What You Need to Know

Month of April: It was a tough month for developed market equity and fixed-income markets as investors were reminded that the fight against inflation is far from over. Fears of 'higher for longer' or even a need to raise rates again pushed most assets into negative territory. There were some bright spots however, with emerging markets defying higher interest rates to rise on improving data and optimism out of China. Copper and Iron Ore also pushed higher in April.

Policy Watch: Neither the US Fed nor the RBA met in April, but speakers were out in force largely stressing patience and the need for more consistent and encouraging data on inflation before policy rates are eased. While the Bank of Japan maintained its current policy, it removed forward guidance, and implied that monetary policy would be data-driven going forward. While the European Central Bank guided markets to a rate cut in June but made no commitment or guidance beyond that.

Inflation Watch: Three stronger-than-expected U.S. inflation figures since January now arguably constitute a trend and point to stalling of progress on disinflation. The quarterly CPI figure in Australia also printed above expectations causing a large change in forward-looking interest rate expectations.

Risk Budget: Equity market volatility rose rapidly in April, with the VIX peaking at 20 before subsiding back into the low teens by the end of the month.

Our Portfolio: Given the risk off tone for the month, our underweight to equities and our high allocation to alternative assets aided performance. With all three multi-asset portfolios outperforming their neutral benchmarks by around 1%.

We made a tactical change to our positioning towards the end of the month as bond yields peaked. We added unhedged exposure to the 7–10-year US Treasury curve via a US listed Exchange Traded Fund (ETF). This position will benefit from a fall in bond yields and/or a rise in the US Dollar. It should also provide a degree of protection should a geopolitical event cause a flight to safety.

Outlook: The dominant theme in markets remains 'higher for longer.' April reinforced that inflation is a key risk and has the potential to unwind the rally in equity markets. Moving forward, price action is likely to be dominated by US economic data prints, inflation readings and rhetoric from central banks.

Geopolitical risks remain present yet any escalation in the ongoing conflicts in Ukraine or the Middle East is heavily discounted by markets. Indeed, as soon as the recent missile attack was launched by Israel against Iran, bond, equity, and currency markets faded the risk-off move within the same day as the strike.

While a soft landing remains the most likely outcome for the global economy, there are other possible scenarios that need to be considered: soft landing, no landing and recession.

How to Position: While the pullback in equity markets was welcome, it was not a large enough correction to justify adding exposure in our view. Valuations remain around historically high levels and bond yields are once again just below levels seen last year when markets were 20% lower than here. We continue to believe strong performance can be delivered by alternative assets and via short duration credit, where running yields provide an attractive alternative to equities.

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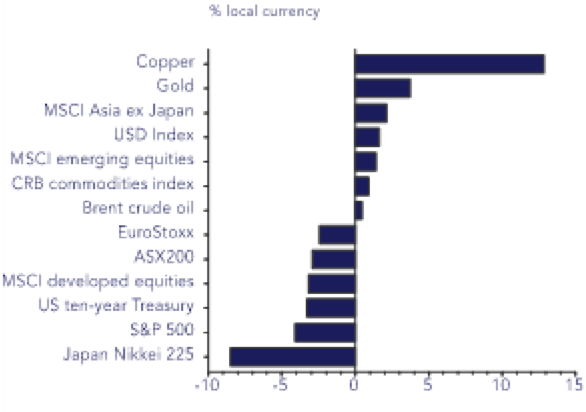
Markets in April

It was a challenging month for developed market equities and fixed income investors as the 'higher for longer' theme remained dominant. Investors once again adjusted interest rate expectations, with cuts being pushed further away on resilient economic data and stalling disinflation.

Chart 1: April Asset Class Performance

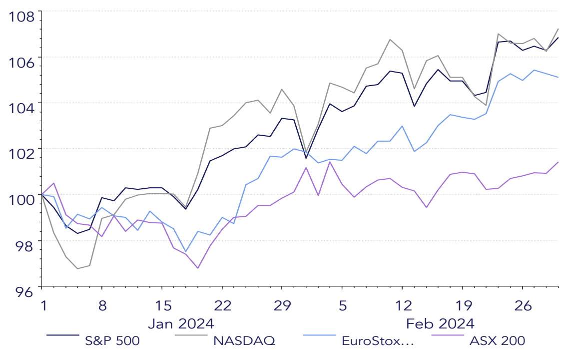


Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The MSCI Developed Markets Index fell (-3.2%), driven by a 4.2% fall in the S&P 500 in local currency terms. The S&P/ASX 200 marginally outperformed the DM World performance, falling (-2.9%) but was beaten by Europe (-0.6%) and Japan (-0.9%) in local currency terms.

Globally, at the sector level, only utilities (4.8%) and materials (0.6%) ended in positive territory. The changing rate environment negatively impacted interest rate sensitive sectors such as real estate (-7.7%) and consumer discretionary (-5.1%). The energy sector (-4.7%) was also weaker despite oil prices ending the month marginally higher.

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



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

Government bond yields recorded large moves; the Australian 10-year government bond yield rose 46 basis points (bps) to 4.42%. Meanwhile the U.S. 10-year Treasury was 48bps higher to 4.68%. The policy sensitive 2-year bond yield rose to 5.03% to reflect higher rate expectations.

Gold continued its strong performance as it once again rallied to a new high of USD 2,330 during the month. Gold is 11% higher year-to-date, which is curious given yields have been heading higher. A relationship which typically exhibits a negative correlation.

Copper was 13.8% higher and the price of iron ore increased to USD $110 per ton as data from China slowly shows signs of improvement. The U.S. dollar index was 1.6% higher and gained 0.5% against the Australian dollar over the month.

Rising bond yields challenged US equity market valuations however, the economic backdrop remains supportive and that has been illustrated in quarterly earnings. To the end of April, 64.6% of the S&P 500's market cap had reported. Expectations are for revenues to grow 3.6% and earnings by 8.9%.

Key Themes

Progress on inflation has stalled, but disinflation trend remains intact for now.

Three stronger-than-expected U.S. inflation figures in a row constituted a trend and a stalling of progress on disinflation. During the month, the US core PCE price index rose 0.32% month-on-month in March, which lowered the year-on-year rate to 2.82% (peak of 5.57%). The core CPI increased 0.36% month-on-month and the year-on-year rate increased to 3.80% (peak of 6.64%).

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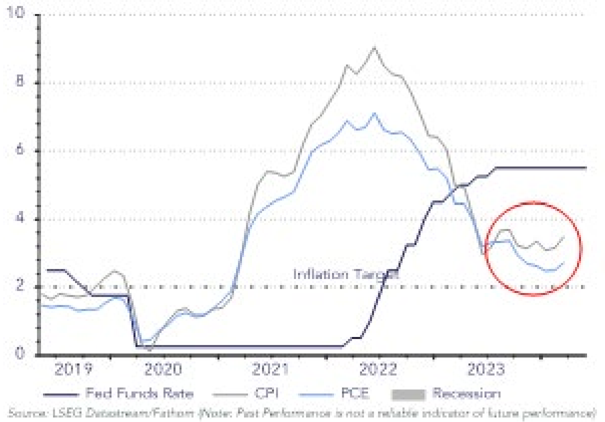
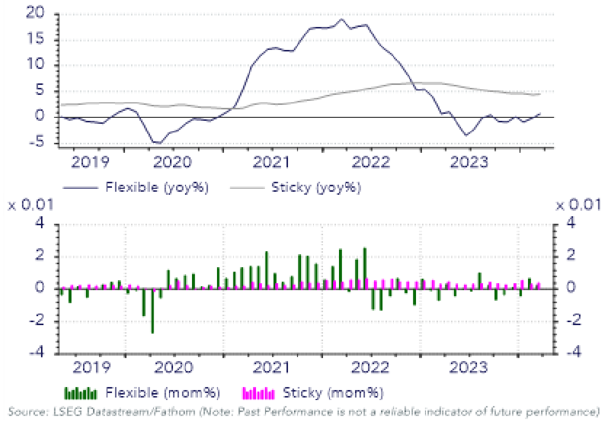
Chart 3: FOMC Fight Against Inflation



The Fed remains concerned about entrenched inflation in the services sector, which dominates the US economy. That is evident in the data, breaking down the PCE inflation basket shows that 50% of core services categories excluding shelter increased by at least 4% (annualized) over the past six months.

Chart 4: Atlanta Fed Sticky Inflation Measure



There has been a notable change in change of tune from central bankers since January, from talk of multiple cuts to stressing their willingness to be patient on cutting rates. Markets have quick to adjust with only one Fed Reserve rate cut expected this year, down from three at the start of the month.

Interest rate and bond markets have been quick to adjust, equity markets less so. Since its most recent bottom in late October 2023, the S&P500 has risen just over 20% as at the end of April, with ~15% of this rise attributable to valuation (P/E) expansion. Bonds yields are now back at the same levels as they were in October 2023, but the market has held on to its gains, defying rising interest rate pressures. Earnings growth has been growing since October, surprising to the upside versus low expectations. What is clear is that the market expects: either (i) earnings growth to continue at its current rate and/or (ii) bond yields to reverse their recent rise, reducing valuation pressure.

Chart 5: US Equity Market Valuation & EPS

Outlook

The dominant theme in markets remains 'higher for longer.' April reinforced that inflation is a key risk and has the potential to unwind the rally in equity markets. Moving forward, price action is likely to be dominated by US economic data prints, inflation readings and rhetoric from central banks.

There is some evidence that labour markets in the US and Australia are starting to show signs of rebalancing, with wage pressures slowly abating. However, this data is likely to be mixed and volatile as we move forward. US Consumer demand remains strong, with many continuing to draw down on savings to spend on goods and services.

The RBA continues to send mixed messages on where the policy rate may go next, with non-committal language in statements, but a more hawkish tone struck by speakers. Interest rate markets in Australia continue to swing between pricing in additional hikes this year, to cuts late this year or early in 2025.

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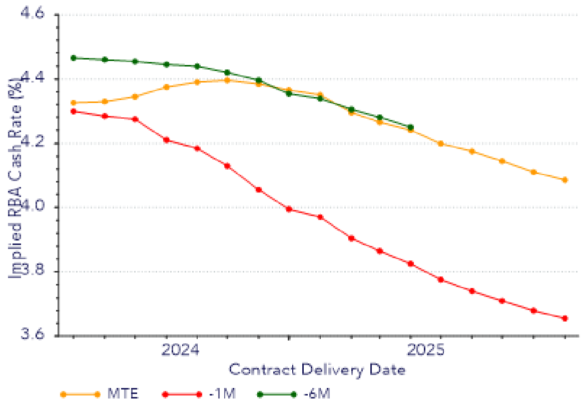
Chart 6: RBA Cah Rate Futures Over Time



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Geopolitical risks remain present yet any escalation in the ongoing conflicts in Ukraine or the Middle East is heavily discounted by markets. Indeed, as soon as the recent missile attack was launched by Israel against Iran, bond, equity, and currency markets faded the risk-off move within the same day as the strike.

While a soft landing remains the most likely outcome for the global economy, there are other possible scenarios that need to be considered: soft landing, no landing and recession. Equities can continue to move higher with continued economic and earnings growth, but a shallower and later interest rate cutting cycle provides a challenge to current valuation levels.

How to Position

Government Bonds

We took the opportunity to add a tactical government bond position to our portfolios in late April as yields peaked. We executed this via a US listed ETF (in US Dollars) tracking the performance of 7–10-year Treasuries.

We believe that while there is still some upside risk to yields from here, buyer support is likely to be strong as investors do not miss another opportunity to step into Treasuries short of 5%.

Given this is not a currency-hedged position, exposing us to movements in the AUD/USD exchange rate. There is the potential for returns driven by both a rally in treasury yields as well as the US Dollar. It provides some downside protection in the event of an economic slowdown, risk-off or geopolitical escalation, as both US bond yields are likely to head lower (prices rise) and US Dollar rally. If inflation continues to surprise to the upside and bond yields rise, then we are afforded some protection from a rise in the US Dollar.

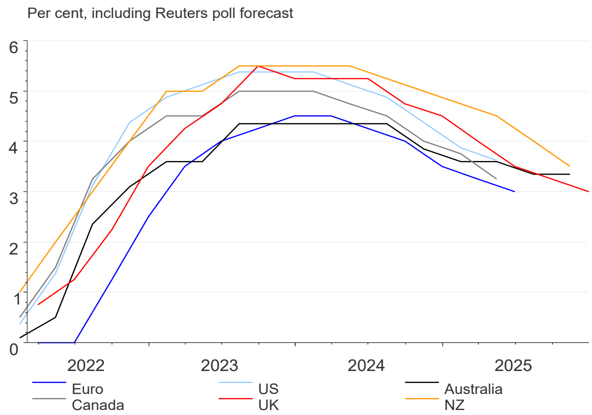
Corporate Bonds

There are some warning signs of distress emerging in the corporate sector in Europe as economic growth slows and high interest rates start to hurt. Insolvencies in Australia are also rising, giving pause for thought. We continue to believe that investors are best rewarded in investment grade credit.

Cash Rates

Cash rates should fall eventually, but the timing remains uncertain. Australian banks are engaged in strong competition for mortgages putting downward pressure on margins, that is likely to put lower deposit rates as banks try to maintain profitability.

Chart 7: Cash Rates with Reuters Forecast



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

Equities

Despite some weakness in April, equity markets have been strong for a few months. Technology remains the main driver of both price performance and earnings, although there have been some periods where the rally has broadened out. While a

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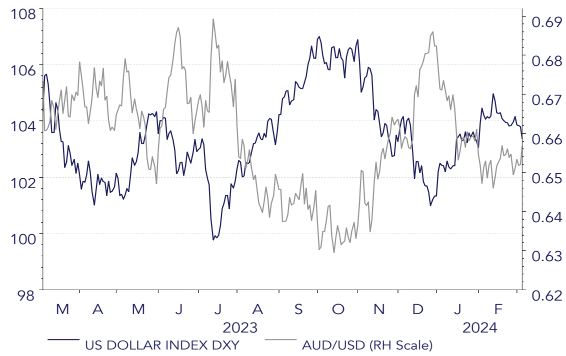
large pull-back appears unlikely, we do not believe equities represent a good risk-reward trade.

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



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

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