MarketSay"

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What You Need to Know

Month of May: May was a good month for most asset classes as optimism about the timing of interest rate cuts and a strong rally in AI linked stocks boosted equities. The MSCI World rose 4.0%, while the emerging market benchmark gained 0.5%. Global bonds also generated positive performance, with strong but slowing economic data. The next move for policy rates across major developed market central banks is likely to be lower, even as there is greater divergence in the pace of easing.

Policy Watch: In the U.S., the return of the soft-landing narrative was in full effect as Federal Reserve (Fed) Chair Jerome Powell struck a dovish tone at the May meeting. Economic data surprised to the downside as concerns around the health of the consumer rose. Several Fed committee members have become more vocal about the need to cut interest rates this year until there is more clarity that inflation has been beaten. Market expectations shifted to pricing just one rate cut in December.

Inflation Watch: Australia's inflation data showed mixed signals, reflecting ongoing inflationary pressures but with some signs of moderation. The Australian Government 2024/25 Budget added to inflation concerns given the front-loading of spending and the cost-of-living support for households. The month-over-month data in the US suggested that inflation was cooling but still present, especially in the core categories, which are closely watched by the Federal Reserve for underlying inflation trends.

Risk Budget: Equity market volatility was rangebound during May, near historical lows for most of the month.

Our Portfolio: Given the risk on move for the month, our underweight to equities resulted in a small lag for our multi-asset portfolios vs benchmarks. Pleasingly, our Global Equity Portfolio outperformed the market by 1.2% and Global Infrastructure beat the benchmark by 1.9% for the month. Performance was also aided by manager selection in Alternative Defensives.

Outlook: While optimism about a global soft landing persists, supporting equity market valuations expectations for a quick return of inflation to target levels and imminent rate cuts are being re-evaluated. Recent inflation data suggests that prices can rise even in a slowing economy. The Federal Reserve and the Reserve Bank of Australia are sending mixed signals, causing volatility in interest rate markets. Rising costs and wages bill remain of concern to many corporates.

Geopolitical tensions remain, but markets seem desensitized to current conflicts unless there is material escalation. The 2024 election cycle is a key focus for investors and is likely to have significant implications for markets, with India's Modi likely to secure re-election, the U.S. presidential race anticipated to be tightly contested, and Australia's upcoming election in early 2025 highlighting economic support in policy agendas.

How to Position: While markets have fallen into a range trading feel over the past few months, there are still windows to move around positions to capture opportunities. We believe that these opportunities remain largely outside of traditional asset classes where valuations in equity markets appear full and the recent bond rally makes fixed income less attractive.

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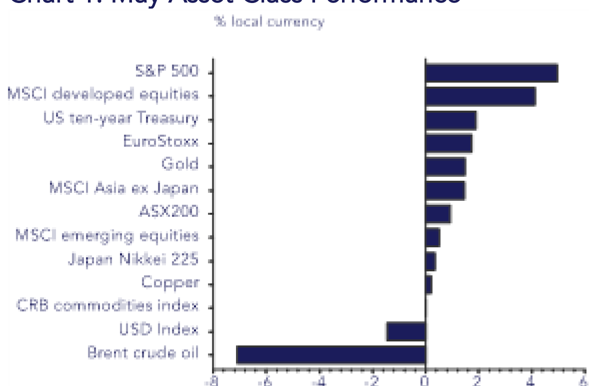
Markets in May

Investor optimism about both the global economy and AI technologies drove equity markets higher in May. Markets also priced in a rising probability that the US Federal Reserve would start cutting cash rates late this year, leading to a rally in bonds. Easing geopolitical fears saw Brent Oil down by US$6.24 through May, to US$81.62/bbl.

Chart 1: May Asset Class Performance



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

The MSCI Developed Markets Index rose (+4.1%), while the S&P 500 outperformed, due to its heavy weight to technology stocks, rising by (+5%) in local currency terms. Meanwhile, the S&P/ASX 200 underperformed, rising by just (+0.9%) in May.

Globally, the IT (+8.7%), Utilities (+7.8%), and Communication Services (+6.4%) sectors lead markets higher in USD terms. The Energy (+0.4%), Consumer Discretionary (+0.5%), and Health Care (+2.7%) sectors relatively underperformed in May.

In Australia, Information technology (5.4%), utilities (3.4%) and financials (2.6%) recorded the largest gains. Communication services (-2.6%), consumer staples (-1.0%), energy (-0.7%) and consumer discretionary (-0.6%) were laggards.

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)

Bond yields moved lower in the US with 10-year Treasury yields 19bps lower to 4.49%. However, there is increasing divergence between central banks on the timing of rates cuts. And this is true in Australia where cuts from the RBA look less likely in 2024. Australian 10 years yields were just 1 bp lower to 4.41%.

Gold added to its recent gains adding 1.8% in May to USD 2,348/oz. Expected interest rate easing by central banks and continued geopolitical risk remain supportive of the gold price.

The Australian Commonwealth Government Budget 24/25 was released in May and was not market moving. The forecast surplus is larger than forecasted by Treasury in Dec 2023, but a smaller surplus than last year. Despite this better starting point, the budget drops very sharply back into deficit across the forecast period, to -$28.3bn in 24/25, which is worse than expected, driven by income tax reductions and cost of living relief. The unknown is whether both cash injections will drive inflation higher.

Key Themes

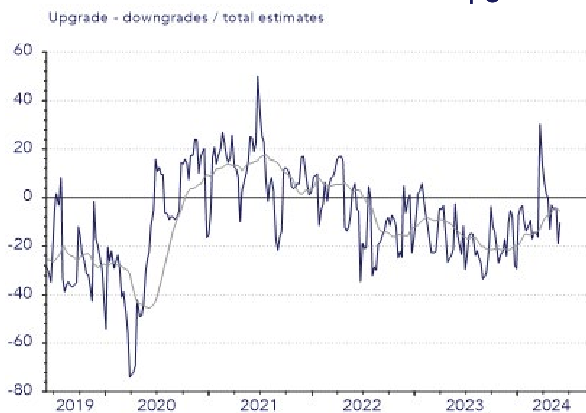
US Equity market valuations remain supported by earnings growth and falling bond yields

Investor expectations for supportive economic growth and lower bond yields are helping to justify the continued rise in equity market valuations. Earnings expectations in the US are also supportive. The consensus outlook for 2024 still expects more than 10% earnings growth in the U.S.

Chart 3: % of S&P500 EPS revisions - Upgrades

Most of the heavy lifting is being done in the technology and communication services sectors, while more cyclical sectors are starting to feel the impacts of moderating economic growth and a consumer growing tired of inflation.

Chart 4: % of ASX200 EPS revisions - Upgrades



Concentration of the S&P500 is working in that market's favour, however the story for the ASX200 is different. The bulk of the index is dominated by Banks who are facing higher costs, competition and lower credit growth and resources that are a mixed bag, with the Chinese economy struggling to break its recent malaise. As a result in Australia, earnings revisions are biased to the downside.

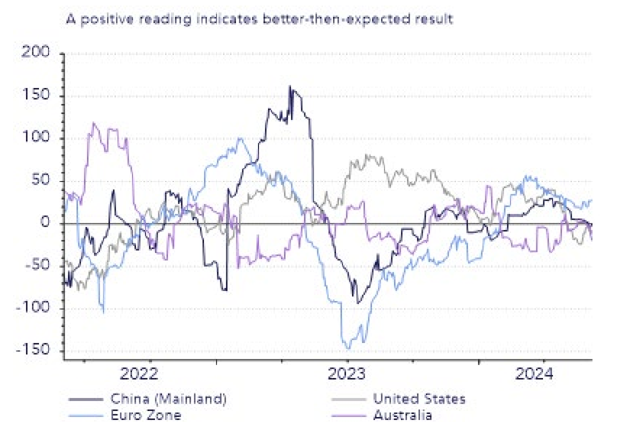
Good news is bad news

There has been a large variance in interest rate expectations that has occurred this year with up to 7 cuts priced in for the US in January, and now a slim chance of just one.

Equity and bond market investors are now welcoming weaker than expected economic data prints on the hope that it makes the Fed ease policy sooner. While a move lower in interest rates supports equity market valuations, there is the risk for equities that lower economic activity likely compromises earnings.

US data is now surprising on the downside, while Australia has been failing to reach expectations for most of 2024, but with inflation remaining stubbornly high.

Chart 5: Citi Economic Surprise

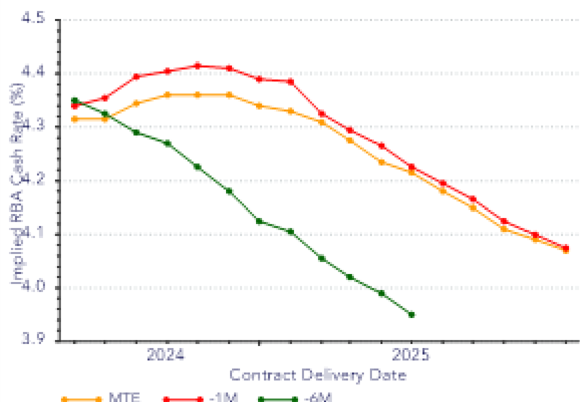


Outlook

While the broadly held faith that there will be a global soft landing is still intact, the belief that inflation will moderate quickly back to target and allow interest rate cuts this year is being re-evaluated in some markets. Recent measures of underlying (core) inflation are reminding investors that prices can reaccelerate even into a weakening economy.

The US Federal Reserve continues to send mixed signals on future interest rates, with cautious statements being offset by hawkish rhetoric from official speakers. This is like the RBA in Australia. As such, the interest rate markets remain volatile, swinging between pricing in additional hikes this year, to potential cuts later in 2024 or early 2025. The ECB looks locked-in to cut rates in June despite lingering inflationary pressures.

Chart 6: RBA Cah Rate Futures Over Time



With labour markets remaining tight globally, the push for a wage catch-up continues to plague businesses. In the absence of productivity improvements, wage rises from here are likely to push pressure on corporate margins and/or pressure to pass on the higher costs in the form of higher prices.

Geopolitical tensions remain a concern, but recent events suggest the markets are becoming desensitised to changes in the current conflicts.

Investors are very focussed on the election cycle in 2024. India looks set to return the Modi government supporting its economic development and market returns. Despite the criminal conviction of Trump, the US presidential election is likely to be a closely fought race and both sides will be keen to announce programs to support the economy. An Australian election is due in early 2025 and the recent budget suggests that spending to support a moderating economy will be an important policy plank of both sides of politics.

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

While markets have fallen into a range trading feel over the past few months, there are still windows to move around positions to capture opportunities.

Cash Rates: Edging lower

While cash rates are expected to decrease eventually, the timing remains unclear. The declining trend is demand for retail deposits from banks appears to continue and will continue to be reflected in diminishing rates on term deposits over the next 12 months.

Corporate Bonds: Proceed with Caution

Early signs of distress in European corporate bonds due to slowing growth and high interest rates continues to raise concerns. Rising Australian

insolvencies further urge caution. We maintain a preference for investment-grade credit.

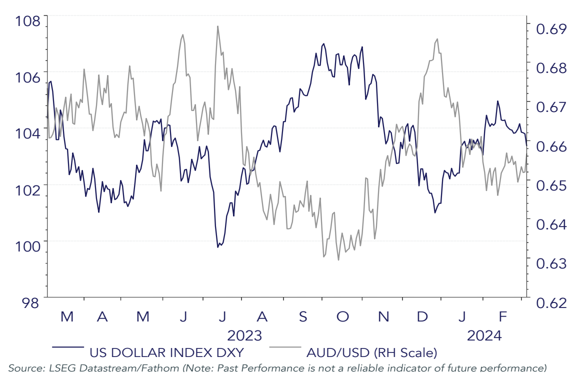
Equities: Risk-Reward Balance Tilts

A limited number of mega-cap technology stocks are driving the performance in equity markets this calendar year. We are now starting to see companies struggle to meet earnings expectations, due to rising costs and softer demand. Earnings misses are resulting in stock prices being punished by investors. While a major correction seems unlikely, current valuations, particularly those in the US, suggest equities offer a less attractive risk-reward proposition.

Currencies: USD Strength May Moderate

The US Dollar was weakened over the past 7 weeks as global portfolios rebalance holdings after a strong run up earlier in 2024. The reality is that interest rate differentials and relative growth rates are likely to support further US dollar strength. The AUD has been bouncing around between US$0.645 and US$0.670 for most of the year and has appreciated towards to the top of that range over the past couple of weeks – partially supported by China’s recent attempts to revive their property market. We continue to believe that the AUD is likely to fall back towards the low sixty cent range.

Chart 8: USD Index & AUD/USD Exchange Rate



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