MarketSay"

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What You Need to Know

Month of June: Economic data weakened globally in June causing most bond yields to fall. Political activity surged with elections in the UK, France, India, and Europe. Europe's elections led to a rightward shift and a snap election in France. In the U.S., election campaigns lack fiscal prudence, potentially fuelling inflation. Equity markets rose, with the MSCI World Index up 2.4%, driven by U.S. and Japanese markets. Emerging markets outperformed, boosted by AI sectors in Taiwan and Korea.

Policy Watch: Some developed market central banks have now started their rate cutting cycles to support growth. The Bank of Canada, Swiss National Bank and the European Central Bank all cut rates in June. Rates were held on hold in the both the US and Australia in June. While the question for investors in the US is when the US Fed will cut rates, in Australia investors are not sure what the next move for the RBA is likely to be, with a potential hike back on the table. The pace of policy easing appears likely to be more modest compared to expectations a few months ago.

Inflation Watch: Australian monthly inflation surged to 4.0% year-over-year in May, well above expectations and was the fastest pace of monthly price rises since November 2023. This followed the higher April monthly figure and suggests the full quarterly figure will be above the Reserve Bank of Australia's (RBA's) inflation forecast, putting pressure on them to raise rates in August. In the US core inflation, rose by 0.3% month-over-month and increased by 3.4% over the past year. The data showed that inflationary pressures are moderating, with significant variations across different sectors.

Risk Budget: Equity market volatility was rangebound during June, 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.

Outlook: While services inflation remains sticky, core inflation is trending lower, and economic activity and labour market strength are moderating. Investors are confident in a soft landing for the global economy, with interest rate cuts expected across various regions by year-end, except for the RBA, which may increase rates due to inflation surprises.

Central banks aim for a steady cash rate, adjusting cautiously despite market expectations of rapid cuts. Geopolitical tensions and election uncertainties in the U.S. and Australia continue to pose risks.

We are monitoring global and Australian corporate earnings reports, with strong U.S. earnings expected. Rising living costs pressure consumers, and wage gains without productivity improvements may impact corporate profit margins. Earnings disappointments, especially in the high-valuation tech sector, could face significant market consequences.

How to Position: A handful of mega-cap technology stocks have been propelling equity market performance this year. Although a major correction seems unlikely, current valuations, especially in the U.S., suggest that equities may offer a less favourable risk-reward balance.

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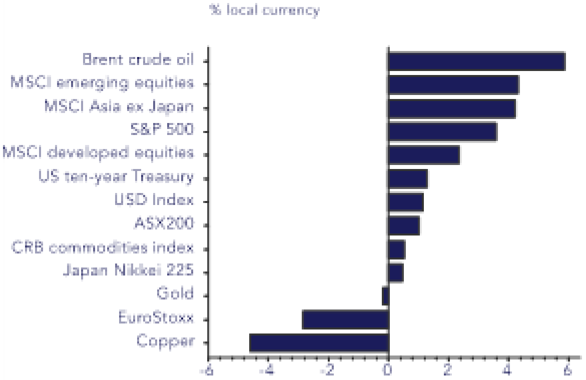
Markets in June

Weakening economic and inflation data has put the 'soft' landing narrative back on track, unwinding the concern that the US economy was "too hot" for the Fed to cut rates. Politics is in focus, with parliamentary elections in the UK, EU and in France. While in the US campaigning has started with doubts over whether President Biden will contest the election in November.

Chart 1: June Asset Class Performance



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

The MSCI Developed Markets Index rose (+2.4%), helped by the better performance of US equities (S&P 500 +3.6%) in local currency terms. Japanese markets also hit record highs as Europe (-1.4%) lagged. The S&P/ASX 200 continues to underperform global equities, rising by just (+1.0%) in June. Emerging markets outperformed (4.3%), supported by the artificial intelligence (AI) exposed markets in Taiwan and Korea.

Globally, at the sector level, the IT (+8.8%), Communication Services (+4.2%), and Consumer Discretionary (+2.3%) sectors outperformed in USD terms. The Utilities (-4.8%), Materials (-3.8%), and Industrials (-1.9%) sectors underperformed in June.

In Australia, Financials (+5.1%), Consumer Staples (+4.6%), and Utilities (+4.6%) outperformed. The Materials (-6.5%), Energy (-1.6%), and Industrials (-0.2%) sectors were the relative worst performers.

Chart 2: Selected Equity Markets YTD Relative Performance (0 = 1 Jan 2024)

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

Government bond yields broadly declined during June as economic data showed a slowing in activity. Australian government bonds yields fell by 10 basis points (bps) over the month to 4.31% and the U.S. 10-year Treasury yield declined by 12bps to 4.37%.

More broadly, the benign macro environment is supportive of corporate bonds with positive corporate earnings and contained defaults rates keeping credit spreads tight.

The price of Brent oil rose 7% to USD 86 per barrel, gold lost some of its recent ground falling by 0.7%. The iron ore price was down 9.4% to USD 107 but remains above where most pundits have been predicting with Chinese steel output remaining resilient, despite a sluggish economy.

The U.S. dollar index was 1.1% higher in June and the Australian dollar (AUD) index gained 0.9%.

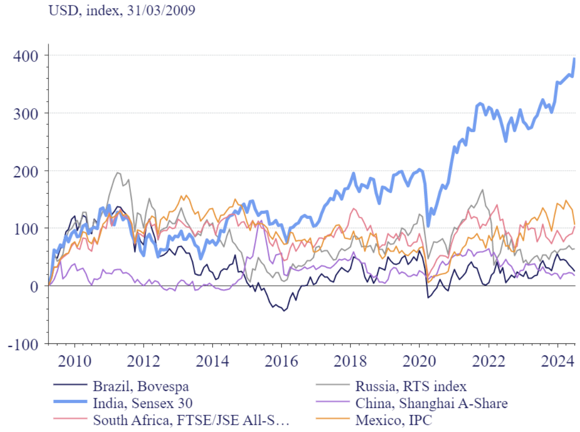
Key Themes

Year of elections continues

Politics was firmly on the agenda in June as elections were called in the UK, Europe, and France, while a lengthy election process in India wound up.

The outcome of the European Parliamentary elections resulted in a shift to the right. The result led to a snap election being called in France by President Macron given his party performed poorly. In the first round of a two-round process, the far-right and far-left leaning parties performing strongly, putting downward pressure on French Equities and upwards pressure on yields.

Chart 3: EM Equities – India Outperforming

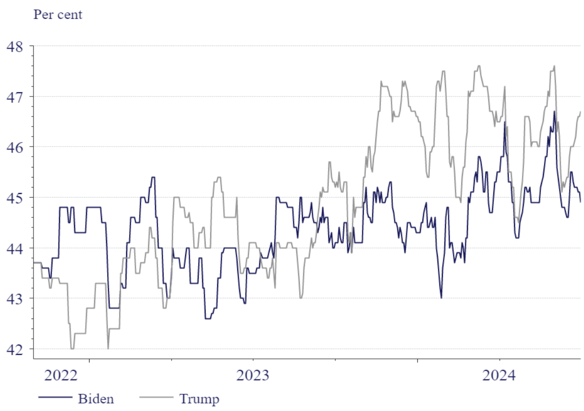


Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Indian Prime Minister Narenda Modi won a third consecutive term but in a tighter election than most predicted. With key allies considered, the BJP-led National Democratic Alliance secured 293 seats. The opposition INDIA alliance, led by the Indian National Congress party, won 232 seats. Indian markets briefly sold off on the result. Without a clear majority investors believed that Modi is less able to continue his economic policies that have powered the equity market to record highs.

The UK election was a forgone conclusion and the impact on markets is expected to be muted, the UK Labour Party bringing an end to 14 years of Conservative government emphatically.

Chart 4: RealClear Polling US President



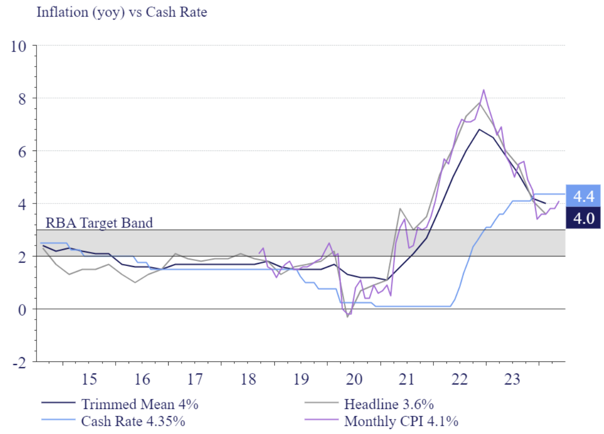
Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

In the U.S., the election campaigning is gathering pace, but neither candidate is laying out any plans to reduce spending or meaningfully raise taxes to address the ballooning fiscal deficit. A less fiscally prudent U.S. government could spark another period of rising inflation.

Soft landing, in some places

Economic data was weaker around the world in June, putting the soft landing and unwinding concerns that some economies (e.g. the U.S.) may run 'too hot' for inflation to fall. Some developed market central banks have now started their rate cutting cycle to support growth as inflation pressures fade, but the pace of policy easing will be more modest compared to expectations a few months ago. Australia is proving an exception to this view, as inflation is looking more stuck than sticky, creating a bias for further tightening.

Chart 5: RBA has no room to move lower



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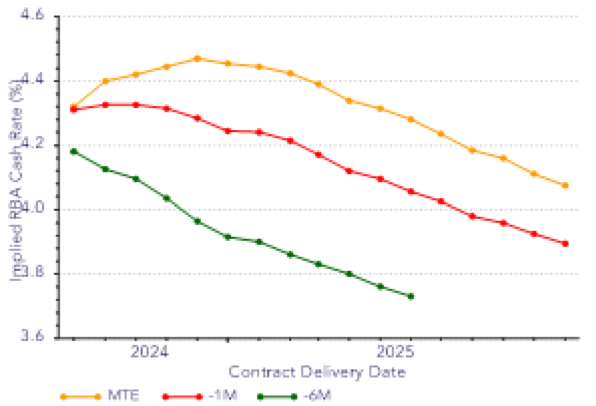
Outlook

While services inflation remains sticky in most jurisdictions, core inflation is trending lower. Signs indicate that economic activity and labour market strength are moderating. Investors are increasingly confident that the global economy is on track for a soft landing, with inflation continuing to move towards target levels.

We anticipate that interest rate cuts will accelerate across various regions as central banks respond to these trends. Many expect that many central banks will implement cuts by the end of the year, with some linking these moves to upcoming global elections. However, the RBA remains an exception, as recent inflationary surprises have led to renewed expectations of further rate hikes to curb inflation.

Chart 6: RBA Cah Rate Futures Over Time



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

Market expectations often fluctuate between prolonged easing and tightening cycles, but central bankers aim for a more balanced approach. Typically, they prefer to maintain a steady cash rate and only adjust when necessary. We believe that central banks will move more cautiously than current market predictions, striving to quickly establish a sustainable rate level for the long term.

Geopolitical tensions continue to pose risks, but markets are showing resilience to ongoing conflicts. The uncertainty surrounding the U.S. presidential election candidates is causing some market unease, and the possibility of an early Australian election is gaining traction.

Looking ahead, we are closely monitoring the next wave of global corporate earnings reports, including the upcoming Australian financial year reporting in August. In the U.S., strong earnings are expected, presenting a challenging benchmark for markets. Consumers are feeling the strain of rising living costs, which is impacting living standards.

Despite softer employment markets, wage gains are being sought, often without corresponding productivity increases, which could pressure corporate profit margins. Earnings disappointments may face significant market repercussions, particularly in the technology sector where valuations remain high.

As we move forward, staying vigilant and adaptable to evolving economic and geopolitical landscapes will be crucial for navigating the investment environment.

How to Position

Over the past few months, most markets have settled into a range-trading pattern, except for the US technology sector which continues to attract investor capital and extend gains. We continue to focus on opportunities to adjust positions and capitalise on market pricing differences.

Cash Rates: Gradual Decline Anticipated

The ongoing reduction in demand for retail deposits from banks suggests that term deposit rates will continue to decline over the next year, adding further pressure to the expected declines as cash rates are cut.

Corporate Bonds: Proceed with Caution

Driven by slowing economic growth and the cumulative impact high interest rates over the past few years, there are increasing signs of corporate distress in many sectors. Rising insolvency rates in Australian construction, real estate, retail, and manufacturing also highlight the need for caution. We continue to favour investment-grade credit, where companies have stronger balance sheets and better access to capital sources to mitigate risk. Private credit markets have an interesting dynamic of strong inflows and deteriorating credit performance. In this asset class, we favour a more conservative approach with deals with a low loan-to-value ratio and uncomplicated collateral.

Equities: Risk-Reward Balance Tilts

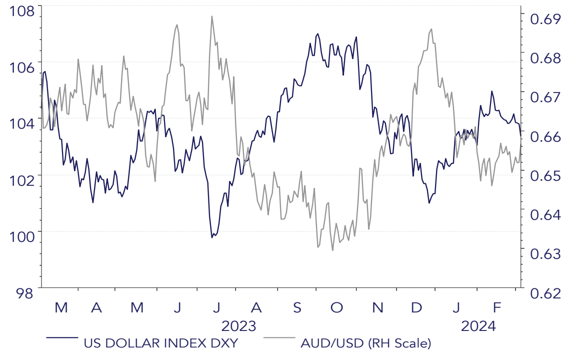
A handful of mega-cap technology stocks have been propelling equity market performance this year. Although a major correction seems unlikely, current valuations, especially in the U.S., suggest that equities may offer a less favourable risk-reward balance. We continue to favour a more conservative approach to equities as we kick off quarterly reporting season in the US, and approach August reporting in Australia. The outlook for China continues to be challenging, putting further pressure on many Australian sectors, noticeably through the softness in commodity prices.

Currencies: USD Strength May Moderate

Differences in interest rate expectations have driven currency movements over the past month, with the Australian dollar continuing to rally on potential rate rises and the U.S. Dollar weakening on September rate cut expectations. We do not think this divergence will continue for long. Relative growth rates are likely to continue supporting the US dollar's strength in the second half of the year.

The Australian Dollar has now traded up towards the top of its 2024 trading range, partly due to China's recent efforts to stabilise its property market. However, we believe the challenges in the Chinese real estate market will be difficult to resolve, and the AUD is likely to fall back toward the lower 60-cent range soon.

Chart 8: USD Index & AUD/USD Exchange Rate



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10 July 2024

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