MarketSay”   say”ers

What You Need to Know

Month of July: Markets had a lot to digest, with US earnings season, mixed economic data, US President Biden dropping out of the 2024 race and geopolitical tensions elsewhere. Against a backdrop of falling bond yields following positive progress on inflation in the US, interest-rate sensitive asset classes outperformed. The month ended with dislocation in risk assets after fears of a US recession came to the fore.

Policy Watch: The US Federal Reserve remained on hold in July, but signalled its confidence to start its easing cycle this year was growing as inflation moderated further. The Bank of Japan surprised with a rate rise and signalled the end of its asset purchase program. This was the catalyst for a large appreciation in the Yen and an unwinding of the “carry trade,” whereby Japanese investors borrow cheaply in Yen to invest in US assets.

Inflation Watch: Investors and the RBA were relieved by the quarterly CPI print, that surprised to the downside. While the data all but removes the risk of the RBA hiking rates again, conditions for a cut remain a long way off, but that has not stopped markets rapidly repricing expectations. The US CPI delivered its 39th consecutive month in which inflation has been at or above 3%, considerable progress since the 6%+ annualised prints through 2022.

Risk Budget: Equity market volatility traded around post-covid lows, before rising in the last couple of days of trading.

Our Portfolio: We took the opportunity in the last week of July/first couple of days of August to deploy a small amount of capital into the weakness in US and Australian small cap equities, reducing our cash position. We remain underweight equities for the moment, in our view, the likelihood of a further pullback is high as investor sentiment remains fragile.

Outlook: We believe recession fears based off a handful of volatile data points is premature. As is the prediction for the Fed to cut by 50bps at each of the last three meetings in 2024, which is being pushed by some. Instead, a slowing of the US economy looks likely, as the impacts of tight monetary policy and fading fiscal support wash through. A return to trend growth levels seen pre-covid is now likely, with the Fed unlikely to panic and should deliver a 25bp cut as planned in September.

In our view, this correction is long overdue, with valuations stretched even as earnings growth remains supportive. This pullback revealed more about stretched positioning than economic fundamentals. Crowding, forced derisking, and lack of liquidity were main contributors to the magnitude of the moves. We believe that any rally may be short in nature, giving those with stretched positions an opportunity to reduce their risk further, with the S&P500 trading at a key support level.

How to Position: Our underweight allocation to equities vs neutral levels, our long duration positioning in credit, US Treasuries and our high allocation to alternatives will all help to preserve capital should markets continue to sell off. Events like this, which are almost impossible to predict with extreme moves stress the importance of diversification and sourcing returns from non-correlated assets.

Broadly speaking bad economic data in the US is now being treated as bad news, rather than spurring equities on rate cut hopes. From here hotter than expected inflation data, a downward revision to employment numbers or soft activity readings all pose downside risks to equity markets.

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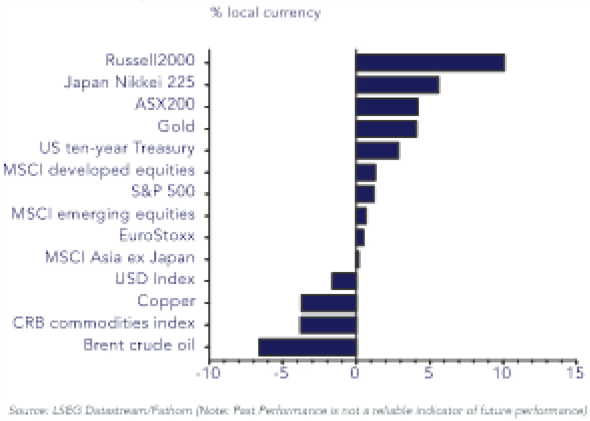
Markets in July

Volatility rose in July as markets had significant political developments, economic data, and reporting season to digest, with geopolitical tensions also rearing their head. Weaker than expected US inflation data early in the month combined with weakening US labour market data at the end of the month, reassured bond investors that the Federal Reserve (Fed) will soon begin cutting interest rates.

Chart 1: July Asset Class Performance



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

At the time of writing, investors now expect the first Fed rate cut in September and are currently pricing almost three US rate cuts this year, with around 150 basis points worth of cuts by June 2025. US 10-year yields also moved lower materially, down 32 bps to 4.05%. The Australian 10-year government bond yield rallied 19 bps over the month to 4.12%, with relief from softer inflation data driving the move locally.

Against this backdrop of falling yields, interest-rate sensitive asset classes outperformed. The Stoxx Global Broad Infrastructure Index was up 7.7% in AUD terms, US Small-cap returns were up 10% over the month, with global REITs posting a 6.0% gain. The MSCI Developed Markets Index rose (+1.3%) in July, while the S&P 500 also increased (+1.2%) in local currency terms. A falling Australian Dollar helped drive the MSCI World Ex Australia Index in AUD terms to +4.08% in July. After a strong run this year, growth stocks were weak, as investors grew more sceptical about the potential for future returns from investment in artificial intelligence (AI) after mixed corporate results.

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)

Elsewhere, commodities lost ground, with the broad CRB Commodity Index decreasing by 3.8% over the month and Oil prices also fell, weighed by weaker demand from China against supply issues arising from tensions in the Middle East. Gold prices rose by US$95.40 over the month to US$2,4226.30 per ounce.

The S&P/ASX 200 outperformed, increasing by (+4.2%). Consumer Discretionary (+9.1%), REITs (+6.8%), and Financials (+6.3%) outperformed. Utilities (-2.9%), Energy (-0.4%), and Materials (-0.1%) sectors were the relative worst performers.

The start of August has seen a wave of violent selling of risk assets following the release of three weaker than expected economic data points in the US, mixed technology earnings and the unwinding of the Yen carry trade. (More on this in the Outlook section below)

Key Themes

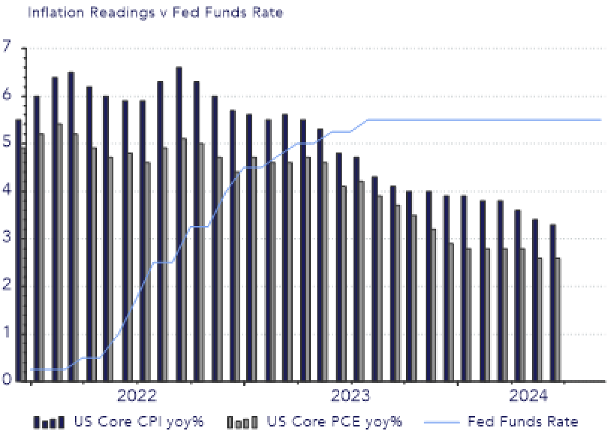
Inflation Battle Over?

The US CPI delivered its 39th consecutive month in which inflation has been at or above 3%. The six-month annualized rate fell to 3.3%, the lowest since October. The path lower has been slower than markets had expected, but its considerable progress since the 6%+ annualised prints through 2022.

While goods inflation has dropped away as supply chains have returned to normal post-covid, services inflation has remained elevated and is only now starting to soften after repeated hikes from the Federal Reserve. Critically, as of last month US Core PCE price inflation is 0.2pp below the FOMC's full year 2024Q4/Q4 projection.

Progress is likely to stall now for another quarter or so given base effects from low monthly increases in the middle of last year, but the trend is encouraging for the Fed that looks likely to make its first interest rate cut in September.

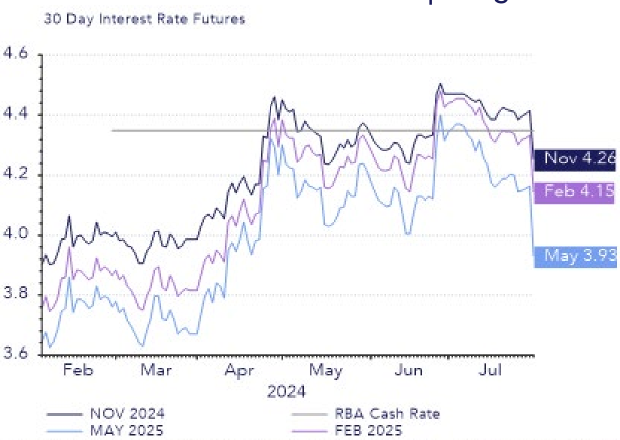
Chart 3: US Inflation Heading Lower



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

The Australian CPI surprised to the downside, which saw a dramatic re-pricing of the RBA outlook by markets. Trimmed mean inflation was 0.84% q/q vs. 1.0% consensus. While coming below the consensus, the annual rate of 3.9% y/y was one tenth above the RBA's May forecast and three tenths above their February forecasts. While the data all but removes the risk of the RBA hiking rates again, conditions for a cut remain a long way off. Markets do not like to stand still (like central banks do) and have quickly adjusted from pricing in the possibility of potential hikes to when the first cut may be.

Chart 4: Australian Interest Rates Repricing Lower

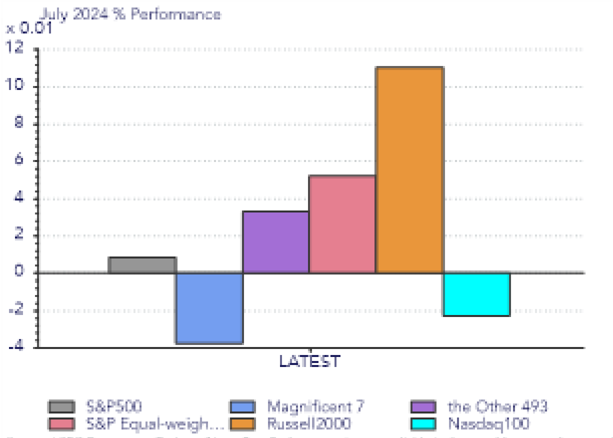


Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Rotation?

With over half of S&P companies having reported, more than two thirds have beaten analysts' expectations, suggesting a resilient US economy is contributing to a broadening of earnings. Earnings from the Magnificent 7 stocks so far, that have driven YTD gains in the US, have been mixed with investors growing sceptical about the earnings growth attributable to AI investment. July saw investors shifting towards small-cap equity stocks, which are more sensitive to interest rate cuts. This led to the largest one-month outperformance of the Russell 2000 versus the Nasdaq 100 in over 20 years.

Chart 5: US Equity Market Rotation



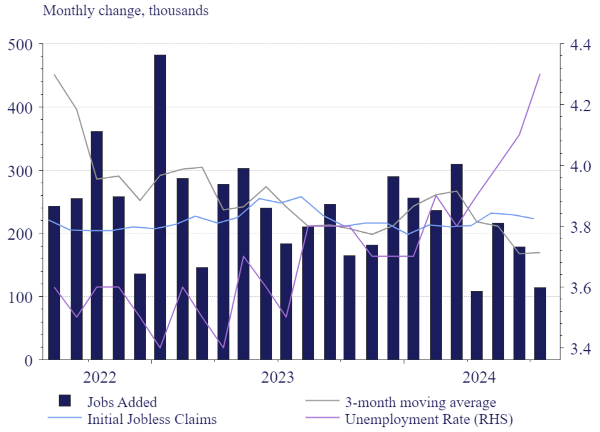
Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Outlook

The start of August has seen a wave of selling of risk assets following the release of three weaker than expected economic data points in the US.

A weaker than expected manufacturing activity (ISM) report started the risk-off move, followed by a rise in jobless claims and topped off with slowing new jobs and a rise in the unemployment rate. This has been compounded by a surprise rate hike from the Bank of Japan and the rising Japanese Yen, resulting in an unwind of the "carry trade" whereby investors borrow cheaply in Yen and buy US denominated assets. These US assets are now being sold, and the currency repatriated to Japan. While mixed mega cap technology earnings and the realisation that investment in AI may not yield immediate results have also impacted sentiment.

Chart 6: US Jobs, not that bad!



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In our view, recession fears based off a handful of volatile data points is premature. As are some forecasters calling for the Fed to cut by 50bps at the last three meetings in 2024.

Instead, a slowing of the US economy was inevitable in our view, as the impacts of tight monetary policy and fading fiscal support wash through the economy. Even so the Atlanta GDP now estimate is at 2.9%. A return to trend growth levels seen pre-covid is now likely, with the Fed unlikely to panic and deliver a 25bp cut as planned in September. Our view is driven by a more recent strong US Services activity print (which is just below 80% of the US economic output) plus the volatile nature of employment data. In the case of the employment numbers, these were impacted by Hurricane Beryl driving temporary layoffs, as well as the participation rate rising in the US summer period.

Other surveys and data points suggest the US economy remains strong. GDP was 2.8% p.a. as at the end of June, with a strong personal consumption component. It would be a stunning turnaround for the economy to go from robust growth to contraction in the space of just a couple of months without an external shock.

In our view, this correction is long overdue, with valuations stretched even as earnings growth remains supportive. This pullback revealed more about stretched positioning than economic fundamentals. Crowding, forced derisking, and lack of liquidity were main contributors to the magnitude of the moves. We believe that any rally may be short in nature, giving those with stretched positions an opportunity to reduce their risk further.

How to Position

Our underweight allocation to equities vs neutral levels, our long duration positioning in credit, US Treasuries and our high allocation to alternatives will all help to preserve capital should markets continue to sell off. Events like this, which are almost impossible to predict with extreme moves stress the importance of diversification and sourcing returns from non-correlated assets.

Broadly speaking bad news in the US is now being treated as bad news, rather than spurring equities on rate cut hopes. From here hotter than expected inflation data, a downward revision to employment numbers or soft activity readings all pose downside risks to equity markets.

Equities: Living on the edge

Given this is the first material pull-back in risk assets in 2024, it is tempting to jump in. We deployed a small amount of capital into small cap equities on weakness, with the view that should markets recover, any rally would be broader than before.

US equities find themselves trading around their 150-day moving average, a key technical support level. We believe that should the S&P500 close below this level, then further selling pressure is probable, given how fragile investor sentiment is at present. It is below this level where we would gradually look to reduce our underweight to equities, most likely via US small caps where valuations are less demanding.

It is difficult to get excited about large cap Australian Equities which have now given up almost all their 2024 gains. Downside potential looks more modest given the small weighting to technology stocks and less demanding valuations. The two sectors that drive the ASX do not look attractive; Resources are struggling given the weak data and sentiment around China, while banks have been a hiding place for many and are more than fully valued. Again, small caps look more enticing to us.

Chart 7: US Equities on key support level

Cash Rates: RBA Higher for Longer

The RBA is still some way away from joining offshore banks in cutting rates. With the banks reporting in August, we will get a sense of how strong credit growth and bank demand for funding is, and it is this that is likely to drive deposit rates and availability in the short-term.

Corporate Bonds: Not a bad place to hide

Credit spreads have been well behaved in the current risk-asset draw down, with spreads modestly wider but not blowing out. Corporate balance sheets remain in solid shape and with the interest rate peak likely behind us now, debt servicing should become progressively easier for many. The challenge for credit from here will be not to get caught up in the selling of other risk assets.

Fixed coupon corporate bonds are benefitting from the move lower in government bond yields. It is important to remember that floating rate coupons will not change until the RBA moves, so running yields remain high. We continue to favour investment grade exposures with an even split of fixed and floating.

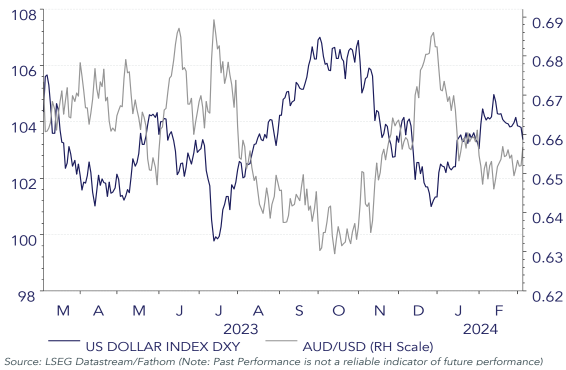
Alternatives: Invaluable in times of stress

We have been very deliberately building out our offering to clients in the alternative asset space. In times of market stress and dislocation, the right alternatives preserve capital and, in some cases, exhibit negative correlations.

Currencies: USD Strength Moderating

The huge move higher in the Japanese Yen has rattled currency markets, weakening the USD in a time where it would typically rally. This has protected the AUD from a larger sell-off given it is seen as a risk proxy. With the US economy slowing and the Fed set to cut rates, USD strength is likely to moderate further in our view, with investors looking to currencies like the Euro as growth surprises to the upside.

Chart 8: USD Index & AUD/USD Exchange Rate



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Sayers Investment Solutions Team

9 August 2024

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