MarketSay"

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What You Need to Know

Month of August: Concerns about a weaker economic outlook dominated markets early in August, leading to a significant shift to risk-off and the seeking of safe-haven assets. However, levels of volatility and heavy selling in equities quickly reversed, with most markets recovering their losses. Government bond yields reset lower as markets increased expectations of cash rate cuts in response to slower economic activity.

Policy Watch: With inflation cooling in most parts of the developed world, central bank attention is now shifting to maintaining economic growth and the labour market gains made since the depths of the COVID pandemic. In his speech at the Jackson Hole Symposium, Fed Chair Jerome Powell acknowledged that "the time has come for policy to adjust," signalling the start of the policy easing cycle in September but not hinting at the size of the move. The Reserve Bank of Australia (RBA) left the cash rate unchanged at 4.35% as expected. Their messaging was hawkish, noting that policy will need to remain restrictive, and that inflation will take some time before moving into the target range.

Inflation Watch: Inflation measures across the world continue to trend lower, but at a slower pace than previous months. Annual rates of inflation in some economies may end up settling at higher than historical levels, with interest rates also staying higher for longer.

Risk Budget: Equity market volatility spiked early in the month, pushing the VIX index to an intra-day high of 65, before trading lower throughout the rest of the month.

Our Portfolio: After the early sell-off in August, we expected markets to continue their downward trend. That did not play out as expected, and with the snap back in equity markets and some underperformance from our key alternatives our performance in August was underwhelming versus benchmarks.

Outlook: September is historically the worst month of the year for US equities. The S&P 500 has fallen -2.3% on average in September over the last 10 years, the only month with consistently negative returns. Since World War II, the average September return has been -0.8%. Seasonally, it is also the most volatile month of the year, with the Volatility Index the VIX, seeing an average spike of ~10% in September over the last 33 years. We are entering the most volatile period of the year.

The market is oscillating between the Fed cutting by 25 and 50bps in September. The Fed has a dual mandate, (i) price stability (inflation) (ii) full employment. Focus is quickly shifting from the inflation mandate to the labour market. The Fed is also likely to be concerned that if it cuts too hard, too early with some inflation measures still above its target, then it risks inflation coming back in a slowing growth environment. To date, the data has not yet been sufficiently weak, nor has enough progress been made on inflation to lock in a 50bps cut.

How to Position: The compensation for jumping into the equity market at these levels is not attractive in our view. The earnings yield, which refers to the earnings per share divided by the current market price per share (the inverse of the P/E ratio), is stretched versus historical levels and is approaching a level not seen since 2007.

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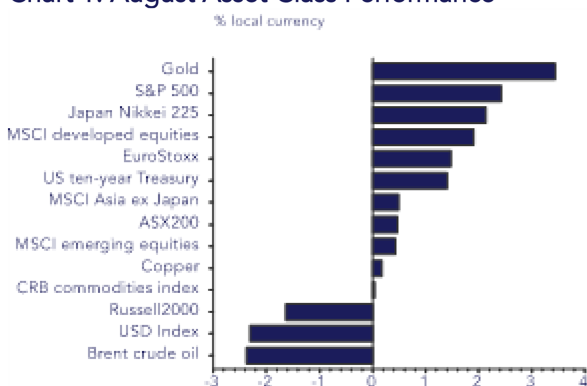
Markets in August

Central banks and concerns about a weaker economic outlook dominated markets in August, leading to a significant risk-off move and a temporary rise in volatility to start the month. However, heavy selling in equities was quickly reversed, with most markets recovering their losses by the end of the month. Government bond yields did not experience the same rebound and reset to a lower level.

Chart 1: August Asset Class Performance



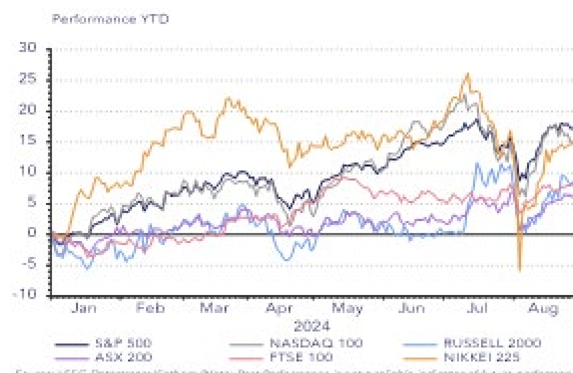
With inflation cooling in most parts of the developed world, central bank attention is now shifting to maintaining economic growth and the labour market gains made since the depths of the COVID-19 pandemic. In July, the U.S. unemployment rose to 4.3%. Although this move was arguably due to temporary factors, it along with other data points particularly in the manufacturing sector, raised concerns about the U.S. economy's strength and increased expectations for aggressive rate cuts by the Fed. This drove bond yields lower with US 10-year yield dropping 14bp to 3.92%, pushing Australian bonds below 4% to 3.97%

The AUD rose 3.4% against the USD during August, as the Fed looked more likely to cut aggressively, while the RBA looks all but certain to stay on hold. This hurt global equity returns for Australian investors. In USD terms, the MSCI World ex-Australia Index rose by +2.6% but fell 1.24% in AUD terms.

The ASX 200 gained 0.5%, topping the performance in AUD terms. However, in local terms, it lagged the 1.3% return in European markets and 2.4% in the S&P500. Japan was in negative territory for the month at -2.9% but is still up 16.0% year-to-date. Australia's small caps reversed the July gains and fell by 2.0% in August.

In Australia, IT (+7.9%), Industrials (+3.9%), and Communication Services (+3.5%) outperformed in Australia. The Energy (-6.0%), Materials (-1.9%), and Utilities (-1.1%) sectors were the worst performers. Globally, the REITs (+6.0%), Health Care (+5.5%), and Consumer Staples (+5.4%) sectors outperformed in USD terms. The Energy (-0.8%), Consumer Discretionary (+0.7%), and IT (+1.5%) sectors underperformed.

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



Brent Oil fell by US$1.92 to US$78.80/bbl., whilst Iron Ore prices rose marginally by US$0.50 to US$102.50/Mt. In precious metals, gold prices rose by US $87.05 over the month to US$2,513.35 per ounce due to dovish Fed expectations, lower rates, and a weaker US dollar which have all been positive for the gold price.

Key Themes

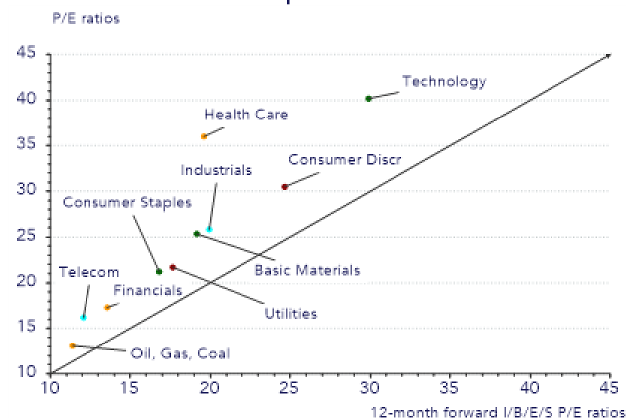
Earnings Season

The ASX August earnings season was an even balance on beats and misses, and just under half of companies reporting earnings in line with expectations. Despite a barrage of news headlines highlighting how tough the Australian economy is and under pressure the householder is feeling, listed retail companies defied sceptics. For this sector there were tentative signs that activity levels have already bottomed. More generally, the outlook was more clouded, as almost half of companies that reported downgraded their outlook and called for rate cuts over the next 12 months to provide tailwinds.

The 2Q earning season in the U.S. underwhelmed when looking at earnings (4.3%) or revenue (0.7%),

a surprise compared to long-run averages. However, margins rose back above 12%. Yet expectations have crept higher for 2025, with consensus expecting 15% y/y earnings per share (EPS) growth. Some sectors are priced for huge growth, with IT leading the way while Financials and energy have more modest expectations.

Chart 3: Valuation expectations for US sectors



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

Recession?

For some time, the US has been a healthy picture of robust growth, however the story may be starting to change. In the US economic data has started to disappoint more consistently. The manufacturing sector's output is contracting while job growth across the economy is also falling back. Consumers are still spending, but savings have been drawn down, and they are becoming more discerning about what and how much they spend. While a deep recession at this point looks unlikely, investors are becoming increasingly concerned that the Fed has left it too late to start their interest rate easing cycle.

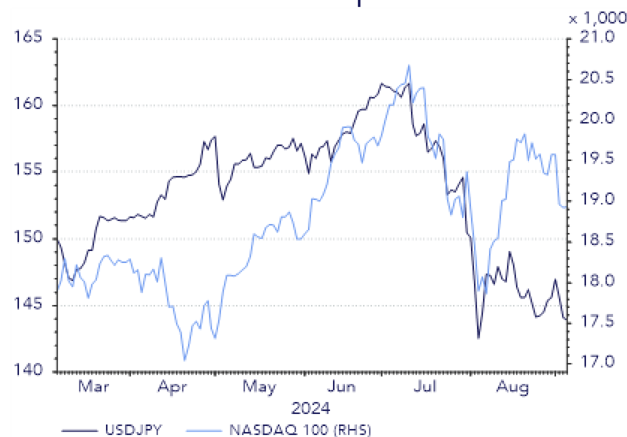
Chart 4: Citi Economic Surprise

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

The Carry Trade?

The Japanese yen (JPY) carry trade, which involves borrowing at low interest rates in Japan to invest in higher-return markets, came under significant pressure. The Bank of Japan's rate hike and hawkish tone at the end of July strengthened the JPY, jeopardising this carry trade and leaving investors scrambling to cover short positions in the currency. The unwinding of USD/JPY carry trades led to a broader equity sell-off across the region, but Japanese equities experienced the steepest selloff. The TOPIX index fell 12.4% in one day before recovering to close down 2.9% in August.

Chart 5: USDJPY and Nasdaq100



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Outlook

September is historically the worst month of the year for US equities. The S&P 500 has fallen -2.3% on average in September over the last 10 years, marking the only month with consistently negative returns. Since World War II, the average September return has been -0.8%. Seasonally, it is also the most volatile month of the year, with the Volatility Index the VIX, seeing an average spike of ~10% in September over the last 33 years. We are entering the most volatile period of the year,

The market is oscillating between the Fed cutting by 25 and 50bps in September. The Fed has a dual mandate, (i) price stability (inflation) (ii) full employment. Focus is quickly shifting from the inflation mandate to the labour market. The Fed is also likely to be concerned that if it cuts too and too early with some inflation measures still above its target, then it risks inflation coming back in a

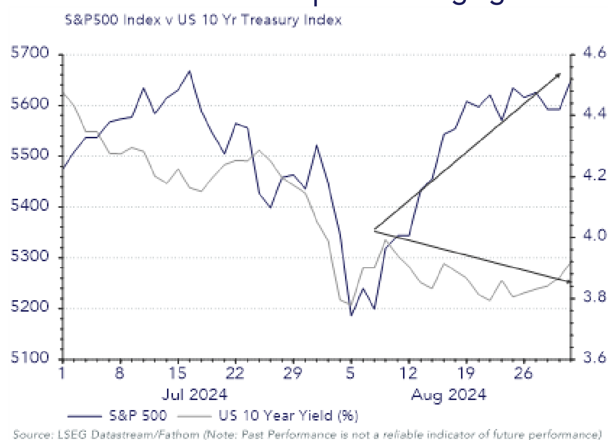
slowing growth environment. To date the data has not yet been sufficiently weak nor enough progress made on inflation to lock in a 50bps cut.

Chart 6: Rate cuts are good for equities… Right?

In our view, if the Fed does cut by 50bps in September, the equity market is unlikely to respond well. It would suggest that the central bank is worried about the strength of the economy and holding on to the labour market gains made since Covid.

Do equities perform well during cutting cycles? As is often the answer to these types of questions; "it depends". History tells us that markets tend to rally into the cutting cycle on hopes of rate cuts and then performance during is mixed. It really does depend on the specific environment the Fed is cutting in. The Global Financial Crisis and Tech Crash are two examples where they cut too late, and the economy was already facing huge contractionary forces.

Chart 7: US Bonds and Equities Diverging Paths



In our view, this equity market volatility and doubt over valuations is long overdue. Since the draw-down in early August, the bond market has traded sideways suggesting the outlook for the economy is clouded, but equities were quick to bounce back to their July highs. Now this resolve is once again being tested, with the earnings assumptions particularly around tech in doubt.

How to Position

After the early sell-off in August, we had expected markets to continue their downward trend. That did not play out as expected, and with the snap back in equity markets and some underperformance from our key alternatives, our performance in August was underwhelming versus benchmarks.

Equities: Back to August lows?

The compensation for jumping into the equity market at these levels is not attractive in our view. The earnings yield, which refers to the earnings per share divided by the current market price per share (the inverse of the P/E ratio) is stretched versus historical levels and is approaching a level not seen since pre-GFC.

Chart 8: Excess cyclically adjusted earnings yield*

With investors focused on weakening macroeconomic data and forward-looking company outlook statements, sentiment remains fragile. We can see markets again testing their August lows during the month ahead as September is seasonally the worst month for equities and is littered with significant macro events and data

releases, including the US FOMC Meeting Sep 17-18.

In Australia, the market appears to be relying on rate cuts in the next 12 months to fuel further gains. These appear to be some way away and with banks looking fully priced and the resources sector weakness look set to continue without China stimulus, the Australian market lacks a catalyst for further gains.

Cash Rates: RBA Higher for Longer

Bank deposit rates are already declining in anticipation of future rate cuts and strong capital flows into deposit products as interest rates remain attractive for savers.

Corporate Bonds: Not a bad place to hide

The credit market remains well supported with strong investor demand for yield, while declining interest rates are alleviating pressure on those corporates who had over stretched their balance sheets. In general credit spreads are broadly in-line with historical averages, with many managers taking the opportunity to derisk their portfolios by shifting from lower to higher credit quality while giving up little in the way of return.

Fixed coupon corporate bonds are benefitting from the move lower in government bond yields. We continue to favour investment grade exposures with an even split of fixed and floating.

Alternatives: Invaluable in times of stress

We continue to advocate clients add alternative assets to portfolios. The recent market volatility has illustrated how valuable these allocations can be, with many of our funds continuing to deliver strong returns regardless of broader market performance.

Currencies: USD Strength Moderating

The USD weakened further in August, as markets priced in varying amounts of interest rate cuts. The AUD strengthened largely driven by the potential for a widening in the interest rate differential between Australia and the US, with the RBA on hold. This strength is despite the continued decline in iron ore prices.

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12 September 2024

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