MarketSay"

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What You Need to Know - November

Month of November: Global equities were led higher primarily by a strong US market driven by a Trump re-election, strong economic growth and solid quarterly corporate earnings. Bond yields headed higher following the election, as the new administration's tax, tariffs and budget proposals pose inflationary risks as well as risks to the budget position.

Policy Watch: The Fed cut its cash rate by 25bps in November, with Fed speakers through the month flagging the potential for a slowing rate of cuts into next year. Another 25bps cut in December looks likely at this stage. Elsewhere, central banks in New Zealand and Sweden cut by 0.5% and the Bank of England cut by 25bps.

Inflation Watch: In Australia, progress on inflation remains slow and messy, with government subsidies distorting numbers. In the US, Core CPI increased 0.3% for the third consecutive month, or 3.3% on an annualised basis. Other measures told a similar story, with inflationary measures stalling.

Risk Budget: Equity market volatility (as measured by the VIX) peaked around 21 around the US election before spending most of the month moderating.

Our Portfolio: Our positioning for a stronger US Dollar assisted with portfolio returns during November, with alternatives and unhedged global equities performing well. Our position in the Russell 2000 was strong. A lack of interest rate exposure also assisted, and an overweight in Credit shielded us from the strong move higher in bond yields.

Outlook: US equities have rallied strongly on the election result and corporate earnings, while the rest of the world is pricing in the risk of higher trade tariffs, slower economic growth and political instability. US equity market valuations are expensive versus historical standards, and major indices have never been more concentrated; it still presents the most attractive equity market in our view. We believe that US small-cap stocks have room to play "catch-up" as a potential rotation out of technology stocks and into domestically focused cyclicals could play out.

How to Position: We will look to fade the rally in the US Dollar at some point, but in the short term, we believe there is some more room for appreciation given current geopolitical risks and the chance that the Fed places further emphasis on a slowing rate of cuts for 2025 at its December meeting. Throw into that mix the risk of sticky inflation readings, a bond market that is wary of the incoming administration's spending intentions and much stronger economic growth, all suggest further rises in the USD.

Outlook for 2025: We will return in January next year with our outlook for the year ahead.

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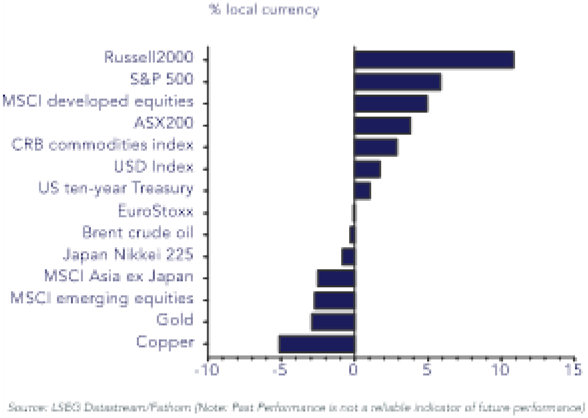
Markets in November

The US election results were the primary driver of market performance in November. The clear and decisive result erased the prospect of a lengthy and drawn out or contested process, which had been feared. Furthermore, Trump's victory and the Republican party securing a (slim) majority in both the House and the Senate fuelled expectations that a more business-friendly suite of policies could be passed early next year.

Chart 1: November Asset Class Performance



Domestically exposed US small caps were seen as the main beneficiaries and gained 11% over the month. While outside US markets, the election result was met with more caution given the uncertainty around trade tariffs and a potential slowdown in trade. Emerging markets underperformed developed markets by 9%. Chinese equities declined due to concerns about a future trade conflict and the continued lack of large stimulus program.

US equities outperformed other regions significantly, with a 6% increase. Expectations for deregulation boosted US financials and the energy sector, while the industrial sector was seen as one of the main beneficiaries of tax cuts and trade policy. The Q3 earnings season was also moderately positive for US equities, with earnings per share growth ahead of expectations at 9% year-on-year. In addition to the election, positive macro data contributed to the rally.

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

The MSCI World Developed Markets Index rose by +5.2% in November in USD terms, with notable sector performance in Energy (+5.2%), Financials (+8.0%), and Consumer Discretionary (+9.4%). However, Materials (-0.9%) and Health Care (-0.8%) sectors lagged behind.

In the ASX 200, sector performance was led by IT (+10.5%), Utilities (+9.1%), and Financials (+7.0%), while Energy (-0.7%) and Materials (-2.6%) underperformed.

The US dollar rally also significantly impacted the relative performance of markets in November. The perception that Trump's fiscal plans could be inflationary and potentially cut short the Federal Reserve's (Fed's) rate-cutting cycle led to the strongest consecutive monthly gains for the dollar in 26 months on a trade-weighted basis.

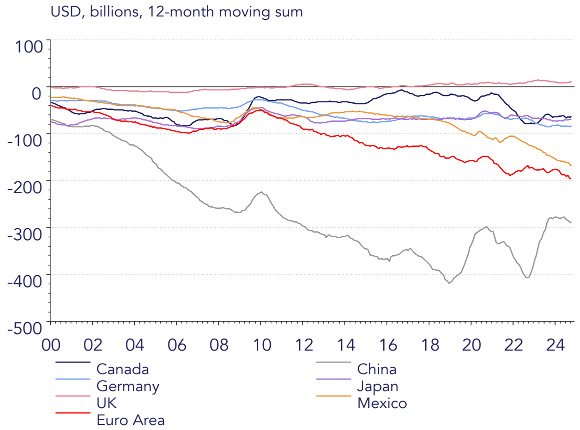
Key Themes

A new Trade War?

President-elect Donald Trump has "announced" via social media a range of large tariffs against major US trading partners and the "BRICS" nations. The threat of tariffs is being used by Trump as a way of achieving other policy goals and election promises on drug importation and illegal immigration. While announcing these measures is easy, getting them implemented will be more challenging. Regardless, markets will be paying attention to social media announcements from the incoming President.

Trump said he would impose a 25% tariff on imports from Canada and Mexico until they clamped down on drugs, particularly fentanyl, and migrants crossing the border, in a move that would appear to violate a free-trade deal and would take time to implement.

Chart 3: US visible trade balances by country



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

Trump separately outlined "an additional 10% tariff, above any additional tariffs" on imports from China. It was not entirely clear what this would mean for China as he has previously pledged to end China's most-favoured-nation trading status and slap tariffs on Chinese imports in excess of 60% - much higher than those imposed during his first term. It is believed that he could use an existing Executive Order from his first term that remained in place under the Biden administration to implement this rise in tariffs.

The more recent announcement came in the form of a threat of a 100% tariff against a group of nine nations — the "BRICS" — if they try to replace the U.S. dollar with another currency.

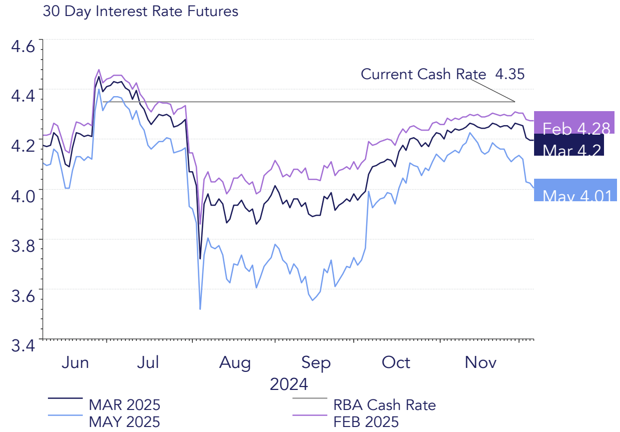
No rate cuts in Australia until mid-2025?

The Reserve Bank of Australia (RBA) kept the cash rate on hold at 4.35% at the November meeting, in line with expectations. The commencement of a cutting cycle now appears to be well into 2025, with expectations shifting from February out towards the end of the second quarter.

The RBA has pushed back that a "within-range" (2-3%) headline inflation reading would be enough to start a rate-cutting cycle. Inflation remains distorted by a range of government subsidies, but the underlying data suggests progress is too slow.

Meanwhile, Governor Bullock reaffirmed that the policy is currently restrictive enough and will remain so until the RBA sees a downward trajectory in domestic demand.

Chart 4: RBA Cash Rate Market Pricing 2025



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

Australia finds itself in an awkward position where economic growth is falling; on a per capita basis, real GDP is going backwards; productivity growth is very low. All of this makes fighting inflation and achieving a "soft landing" tough for the RBA.

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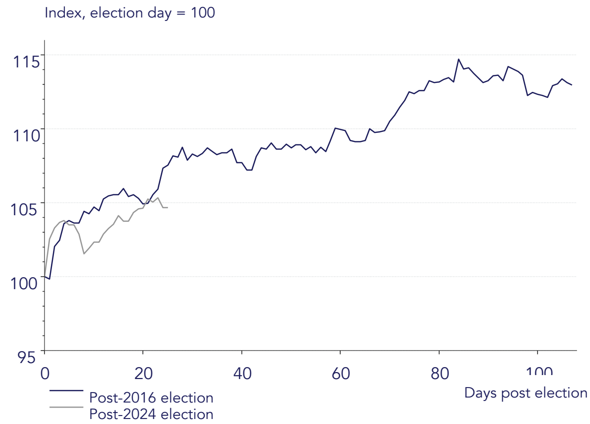
Outlook

Expectations of a return to the deregulation, lower corporation tax and pro-growth policies of President Trump's first term have caused US equity indices to rise since the US election, resembling 2016 price movements.

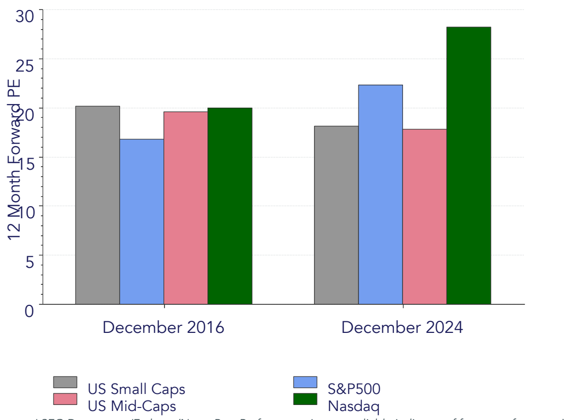
Chart 5: US S&P 500 following Trump election



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

The starting point for markets this time is quite different from when Trump last won an election in 2016. Equities have been powered by strong earnings growth, low interest rates, fiscal stimulus and multiple expansions.

Chart 6: US Equity Market P/E 2016 v 2024

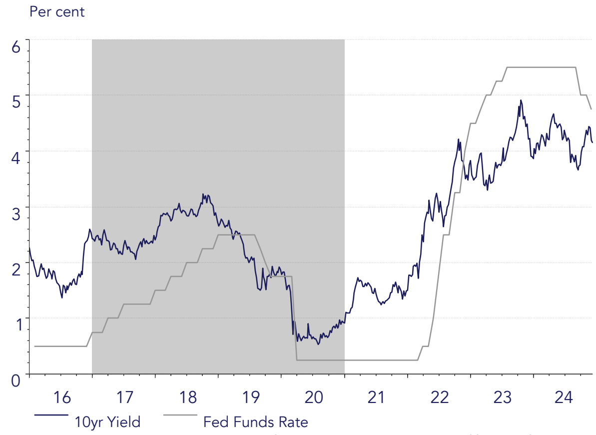


Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

US Large cap stock indices are now more concentrated and are trading on forward price-to-earnings ratios significantly higher than in 2016. The Nasdaq is at 28x vs. 20x in 2016, and the S&P500 23x vs 16x in 2016. Meanwhile, small and mid-cap US stocks are on less demanding valuations than in 2016. The composition of the market is different, as is the price. The path, therefore, from here could look quite different.

During his last Presential term, interest rates were climbing, but yields were largely kept in check, with 10 years only going through 3% briefly in 2018. This time around, the bond market is wary of rising inflationary forces, a large and growing government deficit, ballooning government debt and a Federal Reserve that is now preparing the market for a slowing in the pace of rate cuts from a level much higher than what Trump experienced in his first term

Chart 7: US 10-yr treasury yield & Fed Funds Rate



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

How to Position

We entered a position in US Small Caps some time ago given their less demanding valuation and potentially for benefit from a Trump presidency. US Small Caps performed very strongly through November. We have also remained long the USD via our alternatives and unhedged positions in global equities. In client portfolios, global private equity funds also benefitted from a weaker AUD across November.

Equities: Rally to broaden out further?

It is difficult to justify looking at equity markets outside of the US at the moment. Conditions remain mostly favourable, with strong growth, falling inflation, falling interest rates and an incoming administration that is likely to be business-friendly.

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Europe is struggling with slow growth and political problems in major economies like Germany and France. While Japan will be dictated by what the Bank of Japan does next.

There have been a few false starts to a rotation out of mega-cap technology stocks into other more cyclical sectors. We believe that in the US context, it could be underway. Regardless, small and mid-cap US equities have much less demanding valuations at this point, and we believe room to grow further. While earnings growth for the big tech names is still strong, the consensus is for the growth to moderate from next year onwards.

Cash Rates: RBA to cut later in 2025?

Softer economic growth may push the RBA to move in the first quarter of 2025, potentially as early as February. However, given the RBA made a policy error, leaving it too late to start hiking, it is likely that they will wait for further evidence that inflation is headed back to the target band before moving the cash rate. That means waiting for at least one more quarterly CPI print, which will come in February. It means an adjustment to the cash rate may not occur until the middle of the year.

Corporate Bonds: Conditions remain supportive

The recent backup in bond yields has given investors another opportunity to add duration to their portfolios. We favour doing this through the corporate bond market, where running yields are higher, and investors can take selectively more risk to generate higher returns. With the demise of Bank Hybrids in Australia, investment-grade corporate bonds should become a large allocation in most portfolios.

Alternatives: Outlook for private equity is strong

We would expect the returns for private equity to receive a boost from hereon in. Valuations are less demanding in this space, so entry points are more favourable. While the lack of Initial Public Offering activity has taken away a path to exit in recent years, meaning there are many continuation and secondary market opportunities in this space, with buyers picking up great companies at a discount as funds are forced to provide liquidity to underlying investors.

Currencies: USD to record more gains?

Stronger US economic data and higher yields have pushed the USD higher. That run may continue as markets continue to factor in what a Trump Presidency will look like.

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Sayers Investment Solutions Team

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