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Q1 2024 REVIEW – HIGHER FOR LONGER

Resilient growth, strong labour markets (and ongoing wage growth) coupled with an unhelpful pick up in energy prices means interest rates are set to stay higher for longer. This dynamic saw bond yields surge to more than decade highs that constrained global equity markets this quarter.

Aussie Large Caps Outperform

By the end of a topsy turvy quarter Australia's S&P/ASX 200 recorded a modest -1% total return (including dividends). Investors continued to shun risk sticking to the safety of large cap quality blue chip stocks.

The largest ASX20 stocks on the market were the positive outlier rising 0.3% as higher long end yields continued to support Banks and Insurance sector profit margins while resilient iron ore prices helped major miners.

Conversely, the higher for longer thematic for interest rates creates a headwind for more expensive priced defensive sectors (Healthcare, Staples), high growth (Technology) and more leveraged Utilities and Property sectors.

The major surprise was a better than feared August results and early outlook for the Australian Consumer Discretionary sector despite cost-of-living pressures growing.

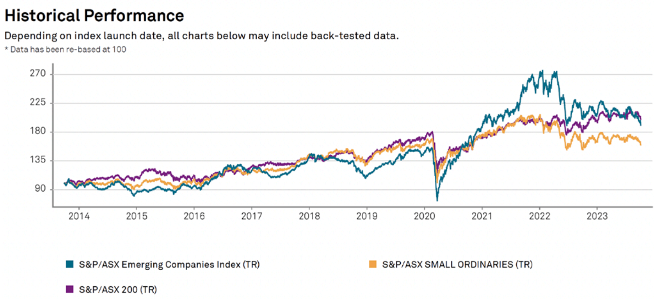
Trading down to lower priced substitutes has been an increasing consumer trend. Major supermarket operator Coles disclosed in their August results that store theft rose 20% in the second half hurting profit margins a trend also seen by other overseas retailers.

While a bit of life has come back into small caps over the past 6 months and select stocks that have been able to manage their bottom line (costs) rebounded strongly, more broadly small caps continue to struggle due to their higher leverage.

The average interest expenses for the Small Ord's Index (ASX101-300 stocks) have risen by 33% over the past year and this interest impost attributed to more than half of the company downgrades in the reporting period.

Consequently, the Small Ord's fell 3% for the quarter taking their underperformance versus large caps to over 20% in the past 2 years creating a relative value opportunity once sentiment improves around risk and the trajectory of interest rates.

Given their sensitivity to interest rates as the cost of capital continues to rise the Emerging Companies Index (micro-cap companies ranked between 350 and 600) with an average market cap of $250m shed even further to be lower by 6% for the quarter.



Energy Bull Market Complicates Disinflation

Inflation linked value sectors like energy outperformed given resilient global demand and OPEC+ oil production cuts that drove the energy complex higher.

Brent Oil rose 27%-to-one-year highs, Newcastle Coal price rose by 25% and low carbon emitting Uranium rose 24% to more than decade highs as governments ramp up lower cost energy solutions for national security reasons.

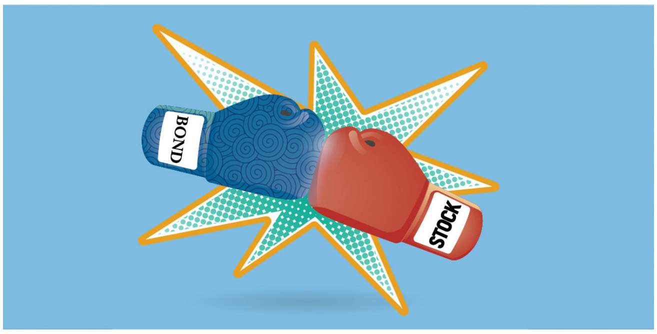
Industrial Metals were mixed while precious metals like gold were soft hitting 6-month lows on US$ strength.

Subdued September

Markets started the new financial year on the front foot rising nearly 3% in July as optimism around falling inflation (and a near-term peak in interest rates) was met by a better than feared US quarterly reporting season driven by mega cap tech stocks and the euphoria around Artificial Intelligence. By August (a seasonal weaker period) momentum faded as a volatile Australian company reporting season highlighted the early stages of a macro slowdown.

A prevailing theme being elevated costs and margin pressures as wages, interest expenses and capital expenditure were all rising.

While results on aggregate were positive and in-line with market expectations, higher costs and lower commodity prices largely meant lower dividend payments than a year ago.



However, company outlooks did disappoint as there were about 4 times the number of downgrades to upgrades for FY24 that saw July's gains fade as did hopes around US Federal Reserve (Fed) policy easing. At the Jackson Hole conference in August, Fed Chair Jerome Powell signalled that rates may have to move higher should economic data continue to positively surprise.

Despite pausing after 11 straight interest rate hikes the Fed doubled down on their hawkish rhetoric at their September meeting by lifting GDP growth forecasts and lowering the peak in unemployment.

The Fed reiterated one further interest rate hike in this year's economic (dot plot) projections while keeping rates tighter (less rate cuts forecast in 2024 and 2025) than previously expected. This new guidance shows Fed officials increasingly believe the world's largest economy can orchestrate an economic soft landing by lowering inflation to target without ruining the economy or leading to major job losses.

Yields Pressure Growth

US economic resilience has been the foundation of recent US Dollar (US$) strength and higher yields, which in turn hurt their stocks particularly the mega-cap tech cohort the Magnificent Seven that led markets higher this year (Apple, Alphabet, Amazon, Meta, Microsoft, Nvidia and Tesla) but are down 6% since July.

The high growth Russell 2000 small cap index plunged 5.5% (-10% from its August peak), the technology exposed Nasdaq shed 4% while the old economy Dow Jones Industrial Average was the relative US outperformer falling 2.5% for the quarter.

Key European markets were weaker, the Stoxx 600 (largest firms across 17 European countries) slid 3% to-6-month lows as the prospect of higher for longer rates weighed along with a weaker economic outlook.

There was broad weakness across Asian markets led by Hong Kong that shed nearly 6% due a larger exposure technology and weaker Chinese property stocks. Many Asian economies struggled as the greenback surged towards yearly highs that saw the Japanese Yen - approach intervention levels. The Australian Dollar (A$) fell to 63.5c versus the greenback (10-month lows) on China growth concerns (the nationals largest export market).

Higher US yields have made the Aussie the worst performing G-10 currency this quarter as the Reserve Bank of Australia (RBA) is expected to extend their pause for a fourth straight month in October.

Housing Less Available and Affordable

Interest rate markets priced in the resilient growth and still elevated inflation. Long end (10/30-year) treasury yields (important for mortgage rates) pushed sharply higher as they need to remain at elevated levels to reduce demand and slow the economy.

The resilience of the Australian housing market continues to surprise as a mismatch between supply and demand remains.

Government policy to create an additional 1.2m homes over the next 5 years appears ambitious given the backlog of existing work and escalating finance costs as mortgage rates have more than doubled over the past 12 months.

Despite these headwinds Australian National houses prices have risen for a seventh straight month (from their January trough) to sit less than 1% below their April '22 peak. Monetary policy works with a lag and 12 interest rate hikes in 14 months by the RBA has so far had limited impact on consumer behaviour with no forced sellers.

Octobers Wall of Worry....again

August and September's reputation of being seasonally weak (worst two performing months since 1970) are now behind us and while Black Swan (rare and unforeseen) events have occurred in October - Wall Street Crash (1929) and Black Monday (1987) - October is on average a positive month for markets.

If recent history is any guide the past three Septembers have on average fallen by 3.5% for the month to then rebound by more than 7% in the fourth quarter as markets climb the wall of worry regrading corporate earnings and central bank policy direction.

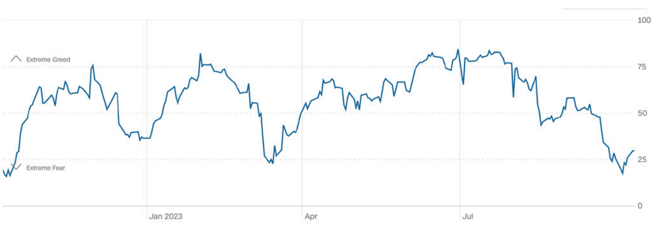
Expectations for US third quarter earnings season in October are low and now provide room for upside surprises as a flat quarter of profits is expected after three declining quarters.

Analysts are currently projecting a strong rebound in Q4 US earnings and double-digit earnings growth in 2024.

The S&P500 forward 12-month P/E ratio has fallen from 19.1x recorded at the end of the second quarter (June 30) to 18x (below the 5-year average) suggesting markets have moved from overvalued back towards fair value on the recent sell off.

While central banks may be near the end of their hiking cycle the battle to reach their inflation goal will be a drawn-out challenge. Complicating the challenge towards a soft landing remains a consumer that is getting stretched by cost-of-living pressures, Chinese debt and property woes appear to be worsening with limited policy assistance to date.

It's deja'vu as another US government shutdown looms that could spill over into the next quarter. All these events are 'known knowns' i.e. not new news to investors so nothing to date suggests a deeper sell off and no evidence of a real capitulation. Current trends indicate things are likely to remain testing in the coming quarter as fear has increased and sentiment has soured.



Legendary investor Warren Buffet's famous contrarian view of the market was to 'be fearful when others are greedy and greedy when others are fearful'.

CNN's Fear & Greed Index, which measures seven different technical indicators to gauge what mood is driving markets, has trended lower since its 'Extreme Greed' peak in late June.

By late September, the index was approaching 'Extreme Fear' for the first time since March, when the collapse of two US regional bank lenders sparked fears of recession - that proved to the best buying levels of the year.

While more cracks in the economy and stock market are likely opportunities are widespread.

Whether it be underperforming small caps, energy opportunities, Artificial Intelligence, overseas stocks that benefit from weaker A$ or resilient real estate niches (listed property trusts trading at an average 25% discount to net asset values) downside is largely priced into many listed equities.

Australia Remains a Bright Spot

There is a lot of volatility and noise in the market right now given the conjecture on what direction the market is heading into next year. The outlook for Australian companies looks resilient and current equity market positioning highlights a degree of cautiousness particularly when investors can get 4-5% on cash deposits as they ride out the volatility.

Even as the Australian economy slows, we believe things aren't as bad as they seem, and Australia remains a bright spot for investors. Australia has superior favourable long term demographic growth trends relative to major developed markets and is endowed for future global growth with arable land to feed 70m people.

We are a top global supplier of critical minerals (lithium, iron ore and uranium) and superannuation savings of $3.5trillion supports the economy.

Recession risks appear lower as cash rates have moved back close to normal levels, RBA policy is less restrictive given inflation has peaked (trending down) and the economy is at full employment. Corporate balance sheets are strong, debt levels generally low and the households are well prepared as many borrowers are well ahead of mortgage repayments and offset accounts are at record levels.

Household wealth is strong as house prices are well above pre-covid levels and rising. 2020/21 was the second-best financial year for superfunds and 22/23 was robust too. We remain cautiously optimistic heading into the end of the year and believe staying diversified matters as investors can finally get attractive returns across many asset classes.