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PMS Q2 2024 - PIVOT PARTY

Global markets exceeded expectations in 2023 as pessimistic first half recession concerns (on contagion fears from the failures of Swiss lender Credit Suisse and several US regional banks) swung wildly to one of optimism of an economic soft landing (no recession) as inflation eased, the economy remained strong and central banks were at the end of their tightening campaign.

Global interest rates were trending lower from their October peak well before the US Federal Reserve's (Fed) dovish December pivot extended an exceptional 'buy everything' quarterly rally.

Now forecasting three interest cuts next year (up from just one cut) in September the Fed's nod to easier financial conditions saw markets swiftly price in an economic soft landing as easing inflation yet still resilient jobs growth fueled a pivot party.

Money sitting on the sidelines in safer cash and bonds moved into riskier assets like equities and the Australian dollar bounced as fund managers Fear of Missing Out (FOMO) chased markets higher.

Santa Comes Early

Despite interest rate, commodity and currency volatility that saw the Australian market trade twice above 7500 index points and twice below 6900 this year it was the rally from those yearly lows in late October that saw the S&P/ASX200 Australian surge 12% or 840 index points.

The month of December alone rose a blistering 7% (its best monthly performance in 3 years) to close the year up 12% - just 0.30% shy of its record August '21 highs.

Sentiment (not fundamentals) were the driver as the outlook for less restrictive policy next year would likely be the tide that would lift all boats allowing the rally to broaden and small caps finally participated along with their larger cap peers.

As greed crept back into markets investors snapped up beaten down small caps as well as the years out of favour sectors Real Estate and Healthcare that led the charge rising 15% and 13% respectively for the quarter. Conversely, the risk-on mood saw defensive sectors Utilities and Staples finish in the red.

Despite rising Middle East conflict (yet positive for the disinflation process) weaker global oil prices saw the Energy sector shed 9% for the quarter. Record US oil production and disunity on oil cartel OPEC production quotas further hurt sentiment, as does the outlook for slower global (Chinese) growth next year.

Bloomberg economist forecast global GDP to grow 2.7% in 2024 (down from 3.1% in 2023) making it the slowest pace (in a non-crisis year) since 2001.

A Materially Good Year

Gains in the Materials sector were mixed but overall, surprisingly strong as downbeat economic data (yet hopes of further stimulus) from major metal consumer China was at odds with surging iron ore prices that rose 25% to US$140 per tonne (20-month highs) to be one the best performing commodities in 2023.

A sluggish Chinese housing recovery saw rising manufactured steel exports that left stockpiles at Chinese ports at four-year lows. Iron ore (our biggest export earner) is a boon for our major resource miners (BHP, Rio Tinto, and Fortescue that all hit record highs) and the Australian economy that could see pessimistic mid-year Treasury forecasts (US$60 per tonne prices by September 2024) revised higher.

As every US$10 increase in iron prices delivers Australia an extra $10bn in national income (that largely flows through to government coffers via mining taxes) this could see a sizeable budget surplus (not deficit as forecast) helping build buffers for cost-of-living relief for households.

Lithium prices plunged and have now fallen 80% from their 2022 peak. Many large established lithium producers have fallen sharply as increased lithium supply has been met with sluggish Electrical Vehicle demand due to tighter financial conditions and lower government incentives.

Many midcap lithium stocks however, surged on rising corporate activity as iron ore magnates (forecasting much higher future prices given the premiums paid) spent some of their riches on the green energy mineral.

Australia's richest person Gina Rinehart spent $1bn on a 20% blocking stake in emerging producer Liontown Resources and fellow iron ore rich lister Chris Ellison (Mineral Resources) was active building strategic stakes in many mid-tier lithium developers.

Gold snapped back after 2 years of losses rising 13% to all-time highs above US$2000oz on expectations of falling US interest rates and US$ weakness.

Uranium rose by 70% as investors gravitated to its appeal as low carbon emitting alternative to fossil fuels while conversely the oil price fell 10% for the year. Helping ease food inflation concerns soft (agricultural) commodities were broadly weaker to see the United Nations food agency world food price index decline by around 10% from a year earlier.

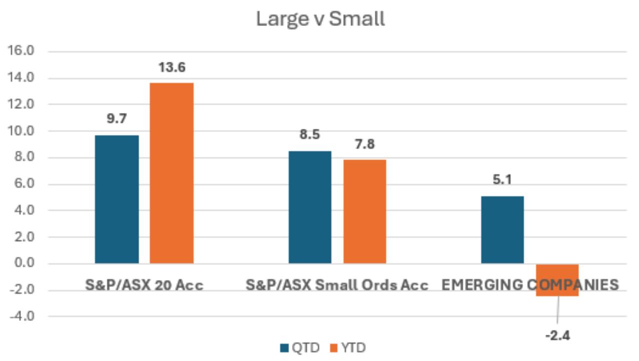
Against a sea of red across the soft commodity complex Sugar was the outlier rising as the pending El Nino climate pattern (abnormal dry parts of Asia) disrupted production. Domestically, good early summer rains are defying early El Nino weather predictions that could create more feed for cattle and sheep and help summer crops for sorghum, rice, and cotton.

Top Heavy

2023 can be characterised as boring is beautiful for Australian blue-chip investors as in an uncertain economic environment investor adopted a risk-off approach and a bias to larger cap liquid sector leaders.

Australia's largest 20 stocks by market capitalisation (the S&P/ASX20) led the quarterly and yearly gains rising 9.5% and 13.5% respectively as the barbell Resources (three largest iron ore stocks) and largest Financial (Commonwealth Bank) all hit record highs.

While our largest Real Estate Investment Trust (Goodman Group) and Consumer Discretionary stock (Wesfarmers) hit multi years highs defying the gloom that higher interest rates (mortgage cliff) will crush property and the consumer.



At the other end of the spectrum the Small Ord's (ASX101-300) stocks rose a healthy 8.5% for the quarter but a lesser 7.8% for the year.

While the S&P/ASX Emerging Market (200 micro-cap companies ranked between 350 and 600) with an average market cap of $250m rose just 5% for the quarter and was 2% lower for the year as a higher cost of capital (interest rates) saw larger discounted equity raisings.

Whether 2024 closes the valuation gap between small and large caps (that had stretched to nearly 30% small cap underperformance over the past 2 years) remains to be seen but current depressed levels are a good starting point for investor returns and there are now ample opportunities for growth investors.

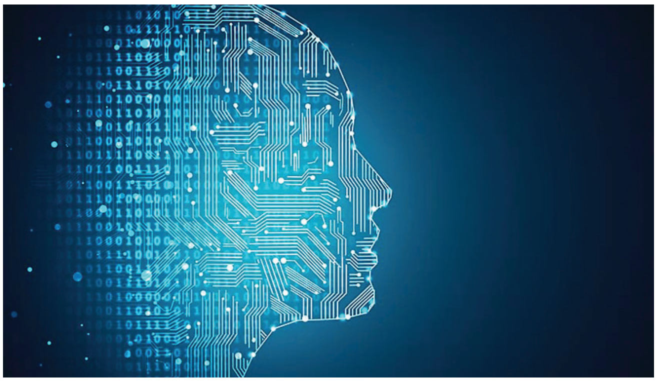
AI Exceptionalism

After a torrid 2022 growth companies significantly outperformed value (particularly in the US) and this year's standout sector was Technology driven by Artificial Intelligence (AI) enthusiasm.

In Australia, the All-Technology index delivered the highest annual return of 36% and tracked the stellar moves of US Mega cap tech stocks (Nvidia, Apple, Alphabet, Amazon, Microsoft, Meta, Tesla) aka The Magnificent Seven that astonishingly have grown to be the same market cap as the stock markets of the UK, Canada and Japan combined.

While the average US stock struggled amid rising interest rates the Magnificent Seven fuelled the US markets rally accounting for more than half the S&P500 24% yearly gains.

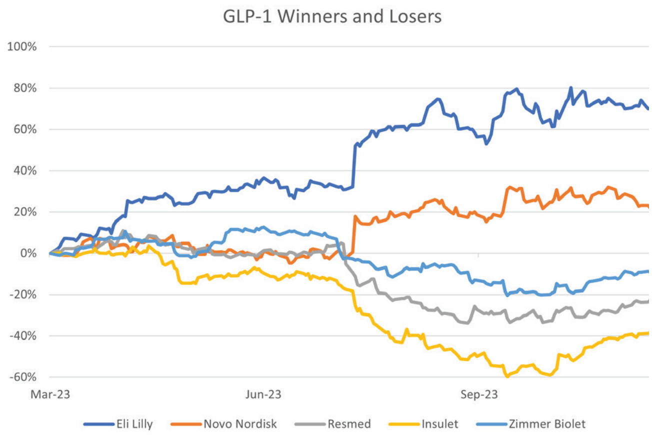
The NASDAQ technology index rose a colossal 43% its third best year after 2009 & 2020. As bond yields (rate expectations) fell and data remained strong the rally broadened to see the small-cap Russell 2000 rise nearly 14% in December sealing its best month since November 2020.



In Europe, the Stoxx 600 index rose 12.5% for the year where Italian (+30%) and German (+20%) markets lead the gains despite a manufacturing recession and much economic gloom in the region. Conversely, in London, UK shares lagged rising just 4% due to their higher value (commodity and financial) exposure relative to growth (technology) that was in vogue as interest rate expectations peaked.

A key highlight in the region was Danish healthcare company Novo Nordisk near 50% yearly move that supplanted French luxury brand company Louis Vuitton (LVMH) as Europe's largest company on excitement surrounding its GLP1 (Ozempic & Wegovy) injectable weight loss drugs.

The popularity of these new weight loss drugs has driven spectacular gains amongst drug development companies (fellow US peer Eli Lilly rose ~60% this year) has been to the detriment of other (potentially impacted) industries such as food, manufacturing, and healthcare.



We believe the market has overestimated the impact of these weight loss drugs on many locally listed Healthcare companies (like ResMed Inc) and pessimism towards the sector that has made it one of the worst in this year – we could see a bit of a reversal in 2024.

M&A 's Got a Pulse

Improved investor confidence and a improved interest rate outlook could see be a catalyst or a pickup in Merger and Acquisition (M&A) and IPO's after a lean period.

While major shareholders scuttled Origin Energy's $20bn takeover and emerging lithium producer Liontown Resources $6.6bn deals it was Newmont's $20bn gold takeover of locally listed Newcrest that drove 2023 deals. Smaller M&A deals amongst the large caps however, didn't endear investor late in the year.

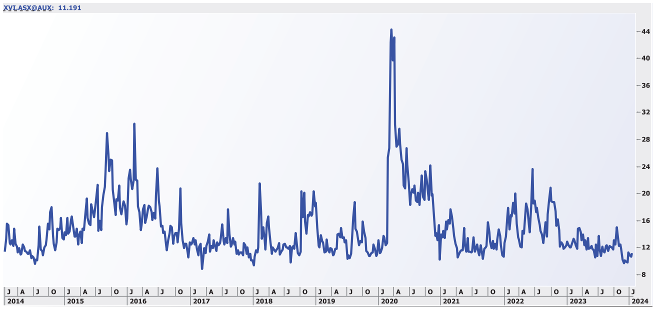
Deals included gas pipeline operators APA Group's $1.5bn deal to buy Pilbara energy assets from competitor Alinta, packing group Orora's $1.4bn French glass bottling acquisition and Treasury Estates $1.5bn purchase of luxury California wine producer DAOU.

A year end rush of deals during the usually quieter December period included early-stage discussion of mega $52bn oil merger between giants Woodside and Santos while listed Sigma Healthcare and unlisted Chemist Warehouse look to create an $8.8bn entity and one of the largest Top 50 companies on the market.

To round out the late deals was a $1.2bn bid for troubled superfund administrator Link Group and a $2.1bn bid for lagging building products group Adbri at a healthy 41% premium.

Confidence or Complacency?

As investor macro concerns abated and peak interest rates were in sight the market price of implied volatility on the Australian market plunged to see the S&P/ASX 200 VIX (volatility index) hit its lowest level since June 2018 as investors removed recession risks and chased growth.



Current, interest rate forecasts (3 cuts by the RBA) appear somewhat optimistic in 2024 given the strength in the economy and the lagged effects of central bank tightening have yet to materialise.

The current goldilocks environment where growth is strong, and inflation is easing may mean policy makers will be reluctant to cut interest rates too early and create a second wave of inflation with potential downside risk for both equities and bonds.

While it's difficult to forecast the next 3 to 6 months and there will be major implications for investor strategies in 2024 on the timing of any policy action. The current outlook suggests the US Fed is probably cutting interest rates before the RBA and while iron ore prices remain elevated this should continue to support the A$ and more cyclical sectors.

While doomsday forecasts for housing and property didn't materialise in 2023, we expect a period of consolidation on markets ahead of easing financial conditions (interest rates) towards the end of the year.

Some relief for households could coincide with the US presidential election (President Biden likely to face Donald Trump in November) that currently has both parties spending up on campaigns.

US Election spending is likely to fuel the US economy (reduce interest rate cuts) and as such a US recession in 2024 appears less likely making 2025 more probable if it eventuates at all.

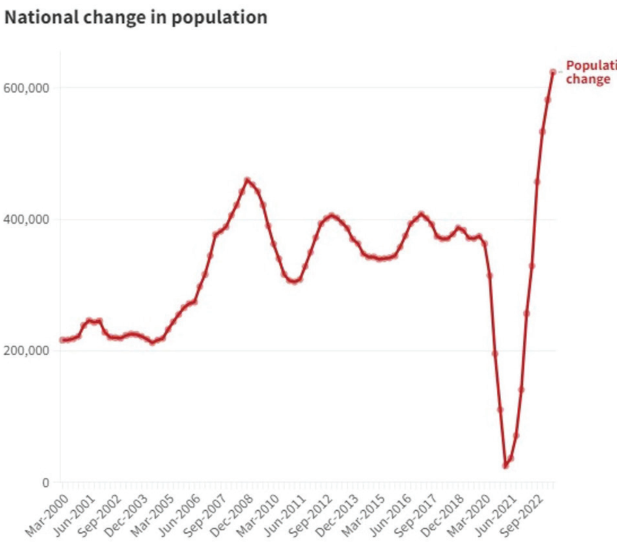
Apart for the growing list of geo-political risk (Europe- Ukraine, Middle East -Israel and ever-present China/Tawain) next year includes elections in the ten most populous democratic countries (US, India, Bangladesh, Indonesia, Mexico, Pakistan, Russia, and Brazil) meaning some currency and market volatility could arise.

While all the uncertainty can make investors uncomfortable doomsday forecast rarely materialise and the biggest lesson (risk) from last year was being uninvested and missing the rally as money market accounts grew and managers chased the gains late in the year. We believe diversification matters as it did in 2023 that saw good returns across all asset classes, but active management will be more critical than ever.

Given volatility is near multiyear lows, equity valuations are starting the year from elevated levels which means it will be critical to be selective especially when many of the largest (perceived) safest stocks are trading at record prices.

Diversification Pays

After the Reserve Bank of Australia (RBA) lifted interest rates by 3% (2022) and a further 1.25% (2023) to 4.35% few would have forecast an 8% rise in national housing prices this year (31% higher than pre covid levels), a sharemarket that's at record highs, an unemployment rate that is still tracking near 50-year lows (3.7%) whilst investors can now earn 4-5% on cash deposits.



While cost of living pressures remain (hurting consumer cash flows and potentially future consumption) right now Australians have never been in a wealthier position given strong returns across all asset classes (shares, property, and cash).

Supporting a continued strong economic outlook is Australia's near record terms of trade, close to 600,000 new migrants (83% of population growth in the year) that has provided a boost to retail sales, house prices and all parts of the economy.