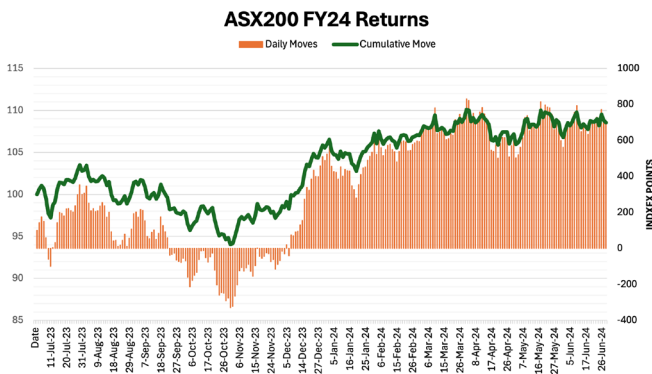




## Q4 2024 - EQUITIES DELIVER IN SPADES

It was a sluggish start to the year for global markets before the upward momentum continued from November in what was an almost uninterrupted run over the past eight months to see the S&P/ASX 200 deliver excellent (above average) returns of 8% or total returns of 12% once dividends were accounted for.

These returns follow similarly impressive 10% price returns (15% total returns) in FY23.



### Size mattered

The returns across market size varied as investors shunned riskier small caps in favour of quality large caps that have strong cash flows, balance sheets, competitive market positions and pricing power to grow earnings and weather the current higher interest rate environment.

The Financial (Bank) heavy S&P/ASX20 outperformed rising 15% for the year, the Midcap50 (stocks ranked 51-100) and Small Ord's (101-300) sized stocks rose a modest 6.5% while the speculative Emerging Companies Index rose just 3%.

### China underwhelms

Impacting the distribution of returns for the Midcap50 and Small Ord's is their greater skew to smaller resources.

**Sentiment towards resources soured as top metal consumer China's underwhelming economic recovery and policy response to date has disappointed.**

The materials sector, which accounts for more than 20% of the market, underperformed, as a weaker iron price dragged down the big iron ore miners. A bright spot was a 15% rally in the copper price as the rollout of electric vehicles, renewables, and electricity grid investment, along with supply concerns, pushed copper prices higher.



The gold price rose 20% to record highs this year as it remains a hedge on political instability and lower real interest rates acts as a tailwind.

### Banking on it

Whilst Investors shunned resources money flowed to the Financial sector and the Big Four Banks that represent more than 20% of the market were the major winners.

**The Big 4 Banks on average surged 32% (including dividends) this year to deliver half of the S&P/ASX 200 indices total returns as tailwinds come from incredibly strong immigration rates, continued strong employment with a shortage of housing and falling new starts has placed upward pressure on house prices.**

This bodes well for the quality of bank home loan books (lower bad debts) and the base case for an economic soft landing has been a big driver of the Australian Financial Sector returns. However, headwinds from rising costs and competition are likely to deliver more modest earnings growth for the sector.



So, the rally in the banks has been more of a function of multiple (not earnings driven) expansion that now leaves the sector overvalued by historic norms and prone to a short pull back or consolidation phase ahead.

**Resilient consumer**

The real surprise this year has been the resilient consumer that represents around 70% of Australian and US GDP. Post Covid savings buffers have largely been exhausted and the cost-of-living crisis disproportionately impacts the haves (asset rich) and have nots (asset poor) prompting government relief via energy bill rebates to help ease the pain.

Consequently, consumer sentiment measures have remained weak over the last two years as 13 interest rate hikes over this period had taken consumer confidence back towards 1991 recession levels.



Though, consumer actions speak much louder than words and while generally higher interest rates have slowed demand the consumer is still spending particularly on experiences such as leisure and travel as prices ease from a year ago.

The combination of cost cutting, and efficiency programs are seeing many retailers report record profits and margins despite the impost of higher interest rates.

**While many consumers may feel cash poor the wealthier consumer is benefiting as household net wealth is at historic highs (+9% in the past year) as house prices have risen 8%, equity values up 12% and short-term savings rates near 5%.**

More resilient spending patterns in the coming year are likely, as higher job security, the benefits of Stage 3 tax cuts (flow from July) and rising asset prices can counter cost of living challenges.

**Tech booms**

As geographical regions are at different points in their economic and political cycle not all markets are treated equally, and performances varied by market composition.

**More broadly globally, IT, Communication Services & Consumer Discretionary sectors were relative outperformers.**

Global markets with a greater tilt to technology such as the US drove the MSCI All World Index (MSC AWI) up 20% for the second consecutive year. As US market represents two thirds of

the MSCI AWI and the top 7 stocks or ~20% of the index are the mega cap US Technology and Consumer Service companies that are benefiting from the upswing in Artificial Intelligence it was unsurprising to see US markets led global markets higher.



Looking at FY24 performances the Nasdaq and S&P500 in the US rose 28% and 22% respectively while small cap Russell 2000 rose a modest 8% a similar type of underperformance versus large caps as witnessed in Australia.

Held back by election uncertainty the CAC40 index in France rose just 1% and this took some shine off the Stoxx600 (Europe's largest stocks by market cap) 10% higher move. In London, the FTSE100 index's greater resource and lower technology exposure resulted in a smaller 8% rise. In Asia, Chinese shares fell 10% while conversely Japanese shares rose 19% as the Yen cratered to 38-year lows supporting export industries.

**Valuation relief ahead**

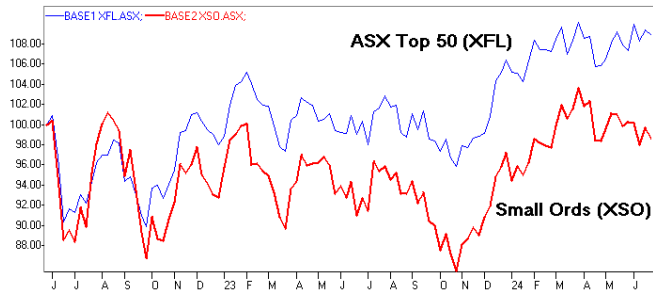
Expectations that an interest rate easing cycle that's started in Europe moves to the US in the second half of this year (Australia more likely in 2025) providing much needed valuation relief for markets that have never been more expensive (excluding Covid) than right now.



Fuelling the rally is optimistic expectations that corporate profits across US, Europe, and Japan will reaccelerate to grow at double digits next year, led by those mega cap US technology stocks on Artificial Intelligence optimism. Meanwhile, Australia's earnings growth will likely be constrained due to the resource sector to deliver low to mid-single digit earnings growth.

**Lopsided market**

The current environment highlights a lack of diversification and has fuelled bubble speculation, as equity market gains over the past two years have been driven initially by low starting prices and increasingly by strengthening revenue and profit growth led by major technology stocks.



A high concentration of narrow market leadership in the US means optimism around these mega tech stocks to generate strong returns is now very high and leaves little room for disappointment in upcoming results.



**The case for rotation to Small Cap laggards is building (should an economic soft landing eventuate) given attractive starting valuations and more generally, the forward growth rates are higher than the large caps as headwinds from higher inflation and interest rates abate.**

**Looking forward**

The markets base case remains for a goldilocks soft economic landing (no recession) outcome would see modest earnings growth, moderating inflation, and modest declines in interest rates ahead.

Under a soft-landing scenario central banks rate cuts will mean there will be better prospects for a reacceleration in earnings

growth for lower quality and cyclical sectors and gains to broaden out. Risks, however, remain on how companies perform (there's little room for earnings disappointments) and how far interest rates do eventually fall from their peak to provide such relief to business and consumers.



In Australia, our inflation trends lag the world by about six months and sticky services inflation coupled with three months of robust jobs growth suggests rates cuts start in 2025 - subject to a deteriorating global growth outlook.

**The wildcard for the local market remains Chinese growth given it dominates consumption of our more than A\$400 billion of resource exports.**

Further China stimulus will be required in the second half of this year to achieve their 5% annual growth target. On expected Chinese support the underperforming resource sector (particularly the small-cap resource stocks) is one area of the market that's looking interesting.

Tempering this area of value is we're approaching a period of historical seasonal weakness (August, September, October) and subdued volatility levels imply a level of complacency that could see markets prone to a healthy short term pull back. Adding to the case for short term caution is we have political uncertainties ahead as snap elections in Europe (UK & France) in July and the pivotal US elections in November could have a wide range of outcomes for global trade and tariffs.

Given the ups and downs of different asset classes over the year it highlights the importance of being diversified across different sectors and geographies.

Once again should bouts of volatility emerge (i.e. corrections 5+% or more) that are normal each year could be the opportunity for investors to add to positions as the outlook for lower interest rates (globally and eventually in Australia) offer better prospects for global growth in 2025 that will also help improve share market valuations.

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