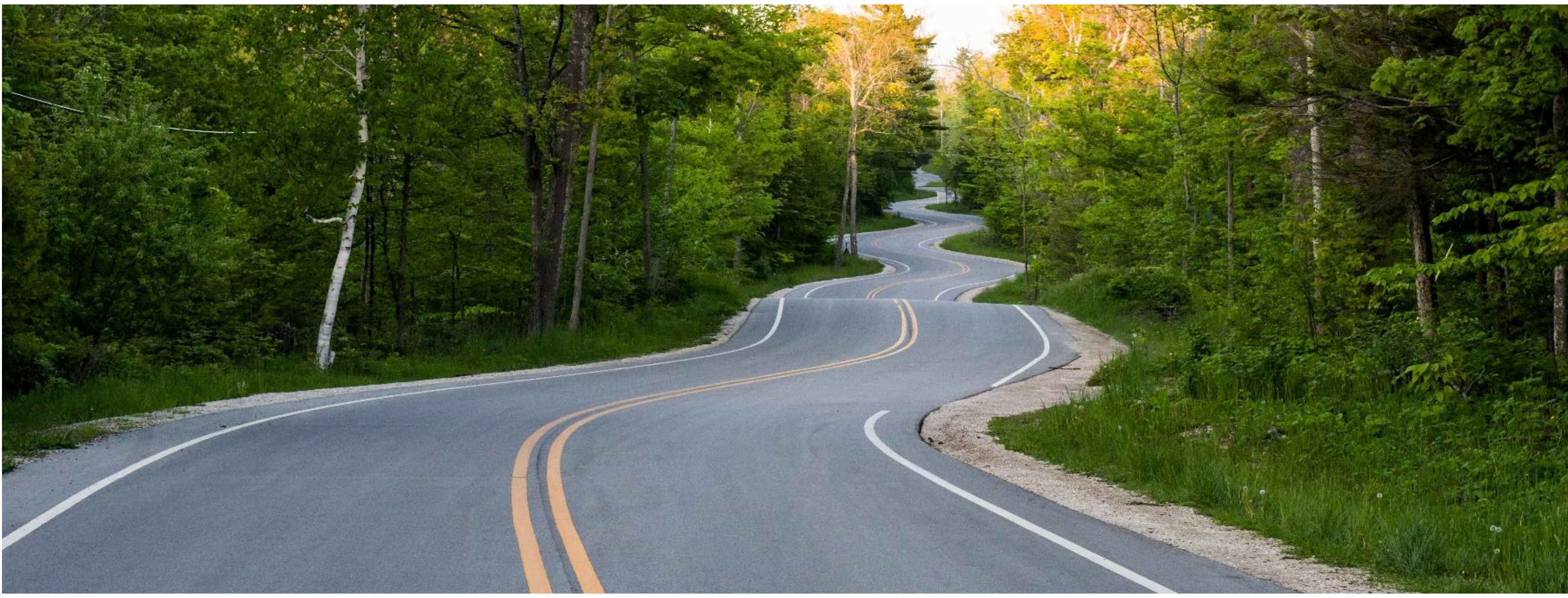


5 December 2023

Investment Markets Report

Nick Ryder – Chief Investment Officer

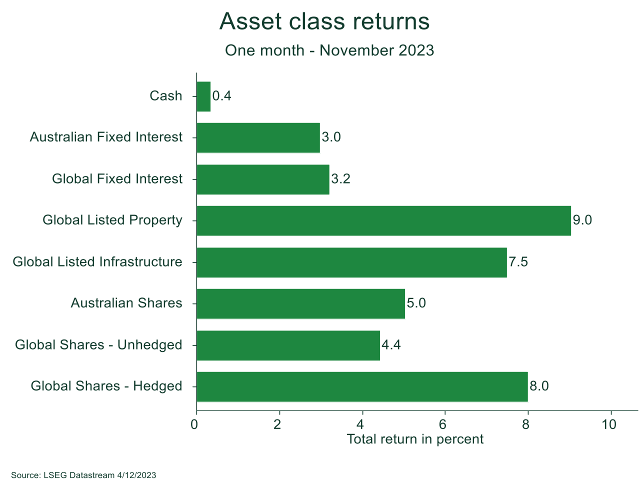
Our investment office unpacks what happened in the past month, current tactical positioning and what this means for our portfolio weightings to different asset classes.

What's changed in November?

Global equity and bond markets reversed recent declines in November as softer inflation data in the US and Europe led to expectations that central banks would be in a position to cut interest rates in 2024, which boosted global equity and bond prices. The rebound in global risk sentiment saw a sharp fall in the counter-cyclical US Dollar and strong performance from Japanese equities, growth stocks and interest rate sensitive sectors such as listed property and infrastructure.

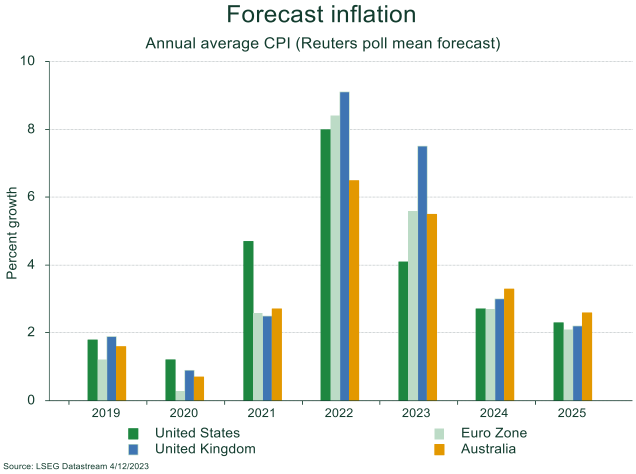
- In currency-hedged terms, developed market equities (MSCI World ex-Australia) rose 8.0% in October. Emerging market shares (MSCI Emerging Markets) rose 3.1% and Australian shares (S&P/ASX 200) gained 5.0%.
- 10-year government bond yields fell 54 basis points (bps) in Australia, 57bps in the US, 36bps in Germany and 28bps in Japan.
- Investment-grade corporate credit spreads in the US narrowed by 21bps to 111bps and US high yield bond spreads contracted by 58bps to 384bps.
- The Australian Dollar rose 3.0 US cents to US$0.6631.
- Oil prices fell 7.4% to US$75.61 per barrel (WTI). Gold rose 1.9% to US$2,035 per troy ounce. Iron ore prices rose 8.1% to US$131.05 per tonne.

Asset class returns – November 2023



Tactical Positioning

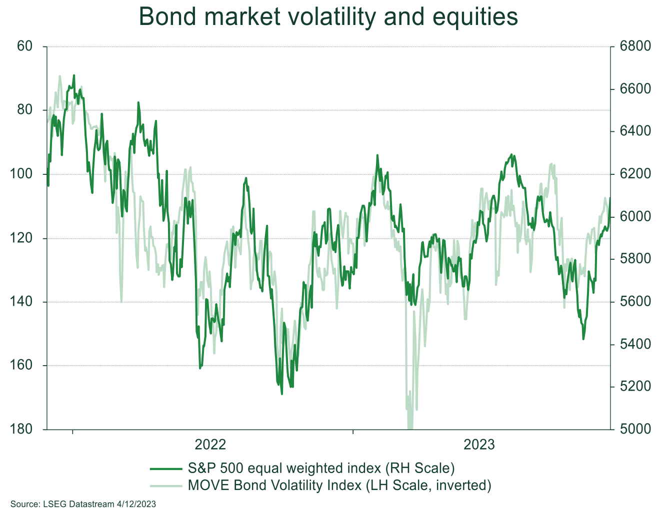
Recent economic data in the US and Europe has given investors encouragement that inflation can continue to normalise without the need for a recession and significant rise in unemployment. This has allowed markets to price in material interest rate cuts in 2024 in the US and Europe which is a dramatic shift from the more recent narrative that interest rates would remain higher for longer. Central bank speakers have also opened the door to non-recessionary interest rate cuts in 2024 although they remain wary about declaring that the war on inflation has been won.



Although inflation in Australia is also coming down, progress back to the mid-point of the RBA's 2-3% target range has been slower than other countries. Domestically driven services inflation appears to be quite sticky and is complicated by the surge in immigration which is creating excess demand for housing and other services. Although the RBA kept rates on hold at its December meeting, there is a material possibility that another rate hike is needed in early 2024 to cement in a faster slowdown in inflation, with rate hikes dependent on incoming data on wages, inflation and overall activity.

In recent months, global financial markets have largely been driven by the US bond market and bond volatility has remained very high which has impacted the prices of other bond markets as well as other financial assets such as equities. Moving forward, we would expect that bond market volatility will subside provided that inflation moderates and investors continue to expect that a recession will be avoided.

With declining bond market volatility and increasing expectations of rate cuts, equity markets could experience a "Santa Rally" with December being the month most likely to experience gains based on the US S&P 500 index since 1945 which shows that it rose 77% of the time in December.



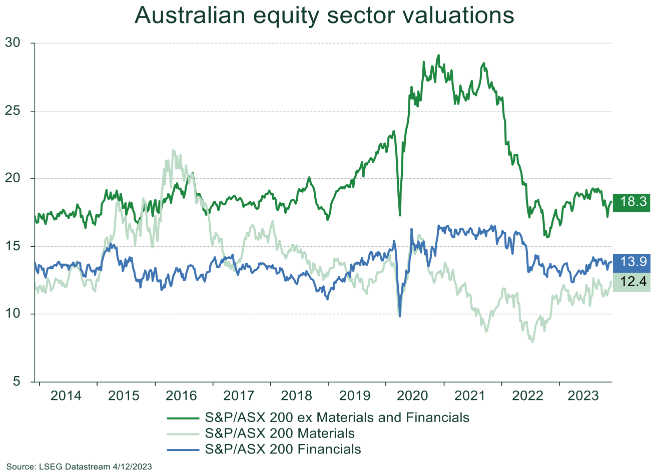
Our tactical positioning remains unchanged this month. Falling inflation, possible interest rate cuts and slower but positive economic growth should be supportive for most asset classes over coming months barring some unforeseen event. Corporate earnings growth is also expected to improve which should be supportive for both equities and corporate credit. We remain comfortable with the recent move to neutralise bond and equity exposures and maintain our tilts within equities to more rate-sensitive quality/growth equities which should outperform in the environment we expect.

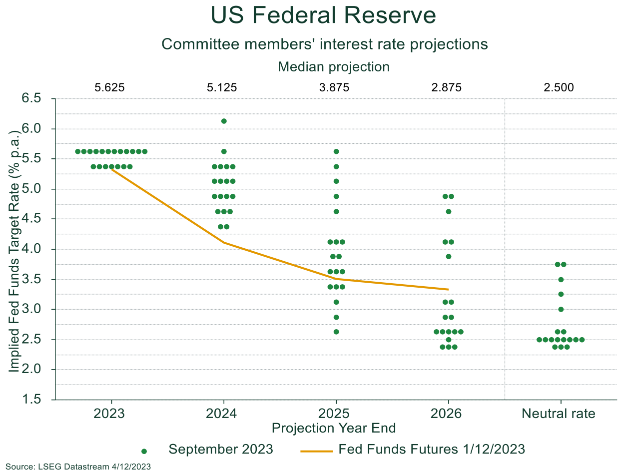
Equities:

Despite a relatively robust earnings season in the US and Europe in October, company management were relatively cautious in their guidance for 2024 which has led to some downgrade of analyst earnings expectations. Notwithstanding the modest downgrades, international equity earnings are expected to grow by around 10-12% per annum over the next two years after being flat in 2023.

With the rise in equity prices in November, valuation multiples are back to around where they were earlier in the year and relative to bond yields, equity risk premia are also comparable to where they were a few months ago. The US equity market is still the most expensive, largely due to the dominance of the Magnificent Seven growth companies (Meta, Alphabet, Amazon, Apple, Nvidia, Microsoft and Tesla) but excluding these companies US valuations are more reasonable.

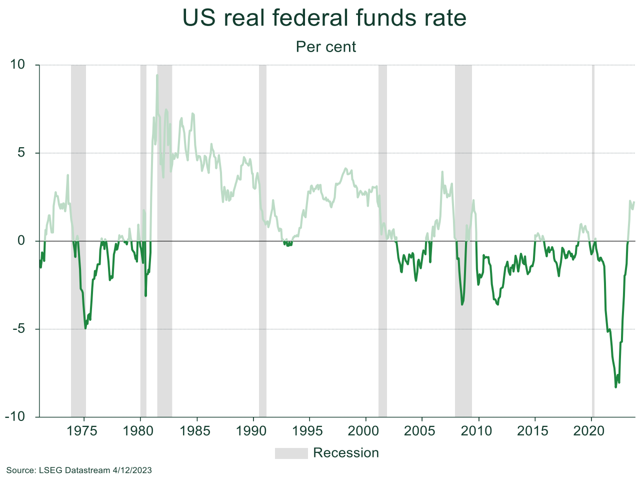
European equities appear very cheap but this is likely due to the more cyclical nature of European earnings and weaker growth outlook. Australian shares sit in the middle between US and European valuations reflecting the blend of low valuations for banks and miners and high valuations for every other local sector. Given our outlook for slowing growth and inflation, we maintain a slight overweight exposure to more rate sensitive styles such as growth stocks which should outperform more cyclical, value driven equities and markets.





Fixed income:

Faster than expected falls in US and Eurozone inflation, some slowing of economic activity and comment's from the Fed's Waller opening up the possibility of rate cuts in three to five months has seen fixed income markets do a full 'U-turn' since mid-October. Higher for longer interest rate views have been replaced with rate cut expectations in the US and Europe in 2024, potentially starting in the first half of the year. The thinking behind this is that central banks will feel comfortable cutting interest rates even if inflation is not fully back to 2% to prevent a rise in real interest rates which would occur if rates were to remain on hold as inflation falls.



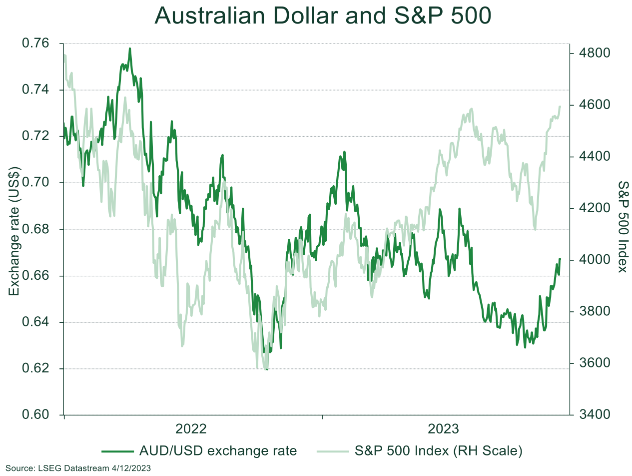
In our view, while we are not ruling out rate cuts in 2024, the speed of cuts in the US and Europe appears aggressive relative to the views put forward by officials that the inflation war is not yet won. One of the reasons that no additional rate hikes were needed was due to higher longer term bond yields (which have subsequently declined) and that most economies remain resilient which increases the risks of another inflation wave or difficulty in travelling 'the last mile' of getting inflation down to 2%. For this reason, we remain cautious that yields could rise again if rate cuts appear less likely in early 2024.

Property and Real Assets:

Global listed property and infrastructure rebounded sharply in November as lower bond yields impacted these rate sensitive equity sectors. Based on our expectations that yields are likely to stabilise, we retain a neutral holding in infrastructure and property. Our view remains that listed valuations offer a more attractive entry point into these asset classes and there is scope for listed and unlisted valuations to converge next year.

Alternative assets:

Liquid alternative assets posted a return of 1.1% in November (HFRX Global Hedge Fund Index in US$) with long/short equity, relative value and event-driven funds showing positive returns while macro/CTA funds generated losses as several price trends reversed. We remain neutral in alternative assets for diversification and portfolio insurance purposes.



Currency:

The Australian Dollar rose 3.0 US cents in November helped by the general risk-on tone in markets which saw declines in the counter-cyclical US Dollar. We prefer global share exposures remain currency-unhedged given the portfolio diversification benefits from currency and high hedging costs.

Current Balanced portfolio positioning summary

Asset Class	Positioning	View
Cash	Neutral	Short term cash rates are close to their peak but rate cuts in 2024 are looking less likely given higher and stickier inflation in Australia.
Australian Debt	Neutral	Retain a neutral weighting with interest rate duration close to benchmark of around five years. Yields are attractive and risks are more evenly balanced given cash rates are close to their cyclical peak and longer-term yields are above the estimated neutral cash rate.
Global Debt	Neutral	Hold a neutral weighting with interest duration close to benchmark of around seven years. Bond yields are more attractive, and risks are more symmetric, and we expect volatility to fall now that inflation is declining which could see official interest rates come down. Credit can perform well in a benign economic environment where default rates remain low.
Alternative Defensive	Neutral	Alternative strategies generally benefit from rising interest rates as cash is used as collateral to secure derivatives and short positions. These strategies have held up relatively well when more traditional defensive strategies, tied to interest rates and the credit outlook, have suffered.
Property & Real Assets	Neutral	Property and infrastructure valuations have reset lower as long-term bond yields spiked but the interest rate headwinds should fade. Listed real estate and infrastructure valuations are more attractive than unlisted and earnings tend to have a degree of inflation pass-through.
Alternative Growth	Neutral	Alternative growth strategies benefit from higher price volatility and dispersion with returns less correlated to broader risk sentiment. Trend-following strategies can often provide insurance-like characteristics by capturing downtrends and uptrends in prices of bonds, equities, commodities and currencies.
Australian Shares	Neutral	The earnings outlook is relatively muted due to weak bank profit growth, derating of major healthcare stocks and limited Chinese stimulus. The economy continues to be supported by high export prices and strong immigration, which is helping offset the impact of higher interest rates. Equity valuations are about average relative to history, but dividend yields are no longer compelling relative to cash and bond yields.
Global Shares	Neutral	Valuations, economic and corporate fundamentals, and investor sentiment suggests a neutral allocation to equities is currently warranted with risks to the upside and downside being broadly equal. Prices have been volatile and closely tied to bond yields but the underlying earnings outlook is reasonable as growth improves and inflation declines.
Currency hedging	Fully unhedged	Headwinds from interest rate differences between Australia and the US, and a weak Chinese currency, have reversed recently and are more supportive of the Australian Dollar in the short term. Prefer to remain currency unhedged in Global Shares as a source of additional portfolio diversification as the Australian Dollar tends to move in line with global investor sentiment.

Strategic Asset Allocation (SAA) and Dynamic Asset Allocation (DAA) weights

Portfolio	Conservative		Moderate		Balanced		Growth		High Growth	
Asset Class	SAA	DAA	SAA	DAA	SAA	DAA	SAA	DAA	SAA	DAA
Defensive Assets	70.0	70.0	50.0	50.0	35.0	35.0	20.0	20.0	5.0	5.0
Cash	15.0	15.0	10.0	10.0	5.0	5.0	2.5	2.5	2.5	2.5
Australian Debt	20.0	20.0	10.0	10.0	5.0	5.0	0	0	0	0
Global Debt	30.0	30.0	25.0	25.0	20.0	20.0	15.0	15.0	0	0
Alternative Defensive	5.0	5.0	5.0	5.0	5.0	5.0	2.5	2.5	2.5	2.5
Growth Assets	30.0	30.0	50.0	50.0	65.0	65.0	80.0	80.0	95.0	95.0
Property & Real Assets	5.0	5.0	7.5	7.5	10.0	10.0	7.5	7.5	7.5	7.5
Alternative Growth	5.0	5.0	7.5	7.5	10.0	10.0	10.0	10.0	10.0	10.0
Australian Shares	5.0	5.0	15.0	15.0	20.0	20.0	25.0	25.0	25.0	25.0
Global Shares	15.0	15.0	20.0	20.0	25.0	25.0	37.5	37.5	52.5	52.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Major financial markets

To 30 November 2023	Latest	1 Month	3 Month	Year-to-date	1 Year	3 Year	5 Year
Equities	Local currency returns including dividends in percentage, not annualised						
Australia - S&P/ASX 200	7087	5.0	-1.8	4.8	1.5	23.0	20.6
Japan - Nikkei 225	33487	8.5	3.4	30.8	22.3	57.1	43.3
US - S&P 500	4568	8.7	1.3	20.3	13.4	31.7	79.6
US - NASDAQ Composite	14226	10.8	1.6	37.0	25.1	19.4	102.7
UK - FTSE 100	7454	2.3	0.9	3.9	2.4	33.1	29.1
Europe - STOXX 600	462	6.7	1.1	12.2	8.4	29.9	50.5
Developed Markets - MSCI World	2366	8.3	1.7	18.8	12.8	29.4	68.3
Emerging Markets - MSCI EM	59780	6.2	0.6	6.9	4.8	-3.6	25.4
Government bond yields	Change in annual yield in percentage points						
Australia - 2 year	4.11	-0.36	0.30	0.70	0.99	4.01	2.10
Australia -10 year	4.39	-0.54	0.35	0.35	0.85	3.49	1.80
US - 2 year	4.70	-0.37	-0.15	0.30	0.33	4.55	1.89
US - 10 year	4.34	-0.57	0.24	0.51	0.64	3.50	1.33
UK - 10 year	4.18	-0.34	-0.18	0.51	1.02	3.87	2.81
Germany - 10 year	2.45	-0.36	-0.02	-0.11	0.50	3.02	2.14
Currencies and Commodities	Change in price						
Australian Dollar (US$)	0.6631	0.030	0.015	-0.015	-0.007	-0.074	-0.067
US Dollar Index	102.82	-3.84	-0.80	-0.70	-3.13	10.95	5.55
Gold (US$/ounce)	2035.45	38.55	93.15	223.10	281.95	272.90	817.90
Iron Ore (US$/tonne)	131.05	9.85	14.52	14.49	30.45	0.44	66.35
Crude oil (WTI, US$/barrel)	0.6631	0.030	0.015	-0.015	-0.007	-0.074	-0.067

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