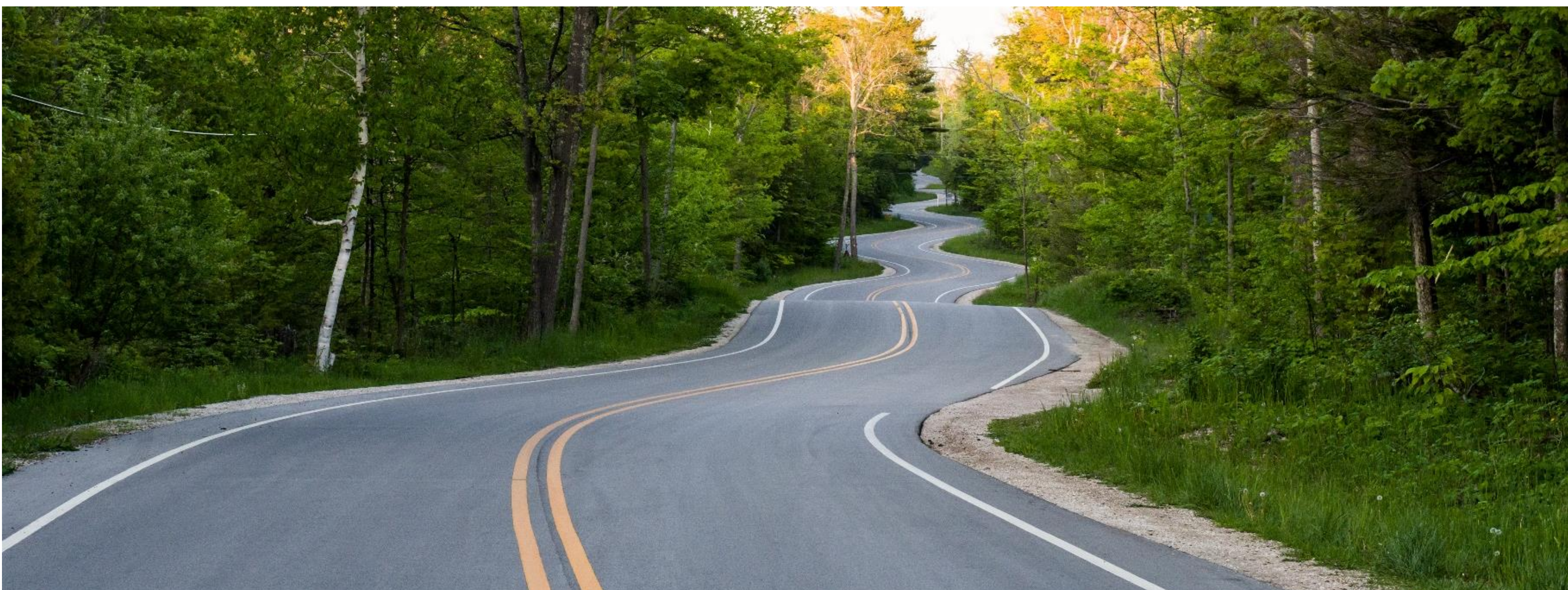
StanfordBrown Private Wealth



6 February 2024

# Investment Markets Report

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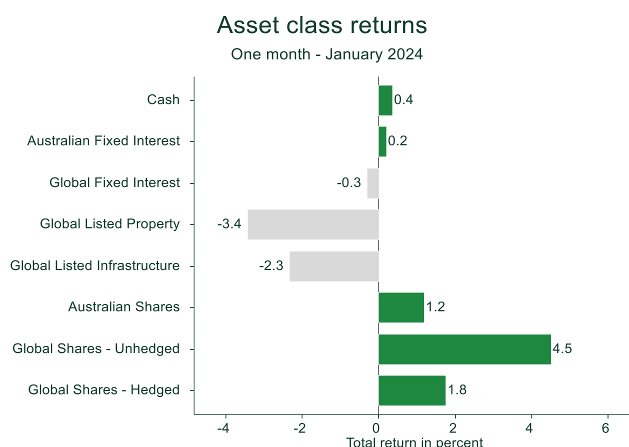
*Our investment office unpacks what happened in the past month, current tactical positioning and what this means for our portfolio weightings to different asset classes.*

## What's changed in January?

Global equity and bond markets extended their Santa rally into January as economic data showed that inflation has continued to moderate which has increased expectations that interest rates have peaked. Pricing of substantial interest rate cuts, which had helped drive markets higher in late 2023, were wound back in January as central bankers in the US and Europe pushed back on the need for imminent rate cuts preferring to wait and see that inflation is falling sustainably back towards their 2% targets.

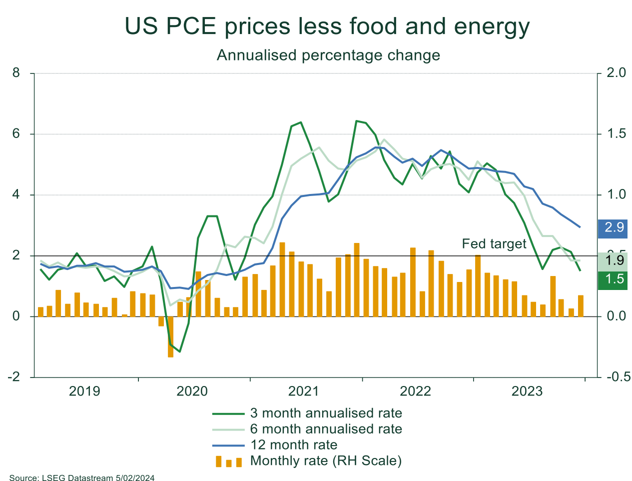
- In currency-hedged terms, developed market equities (MSCI World ex-Australia) rose 1.8% in January. Emerging market shares (MSCI Emerging Markets) fell 3.5% as Chinese stocks continued to fall. Australian shares (S&P/ASX 200) gained 1.2%.
- 10-year government bond yields rose 9 basis points (bps) in Australia, 8bps in the US, 13bps in Germany and 10bps in Japan.
- Investment-grade corporate credit spreads in the US narrowed by 2bps to 102bps while US high yield bond spreads widened by 20bps to 359bps.
- The Australian Dollar fell 2.1 US cents to US$0.6611.
- Oil prices rose 6.1% to US$76.28 per barrel (WTI). Gold fell 0.8% to US$2,053 per troy ounce. Iron ore prices fell 6.3% to US$131.85 per tonne.

## Asset class returns – January 2024



## Tactical Positioning

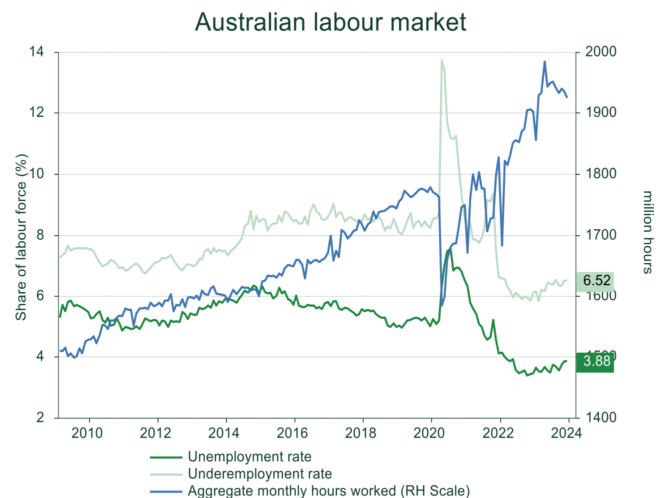
Global inflation data has generally come in softer than expected which has given investors greater confidence that major central banks can begin to cut interest rates in 2024. As has often been the case over the past couple of years, markets moved to price in aggressive non-recessionary cuts in the US and Eurozone starting as soon as March. Central bank officials have recently pushed back on market pricing saying they need to see more evidence that inflation is on a sustainable path towards 2% before cuts begin.




If we look at the US Federal Reserve's preferred inflation measure, core Personal Consumption Expenditures (PCE) prices, then on a three- and six-month annualised basis inflation is already back at or below the Fed's 2% target. At the most recent meeting of the Fed, Chair Powell said the Fed is looking for a continuation of the better inflation data and a March cut is probably not the most likely case. Recent US labour market data has been much stronger than expected and further reduced the probability of a March rate cut.

The takeaway for investors is that outlook for the US economy has strengthened and investors are now more focussed on the growth rather than worrying about inflation. If inflation continues to decline in line with recent trends, then modest rate cuts are likely from mid-2024, possibly starting in May, and this goldilocks environment should continue to provide a reasonable backdrop for growth assets such as equities.

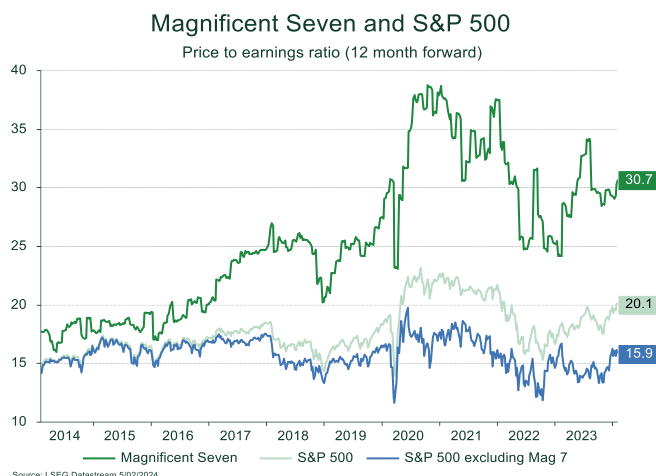
In Australia, the economy is expected to continue to slow with recent retail sales data confirming that households remain under pressure from higher mortgage rates. There is also some tentative signs that employment has begun to soften and normalise back towards pre-pandemic levels which should help lower wage pressures and services inflation. This should give the RBA greater confidence that additional rate hikes are not needed, particularly given December quarter inflation was a little below RBA and market expectations.

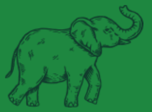



As we discussed in our 2024 investment outlook, we see risks as being broadly balanced across the major asset classes and remain neutral in equities and fixed income. The Santa rally in late 2023 brought forward some of 2024's potential returns and has therefore limited further near-term upside in our view. However, we consider that the economic fundamentals are still supportive for equities while valuations and sentiment are not yet at levels that would warrant a lower exposure.

### Equities:

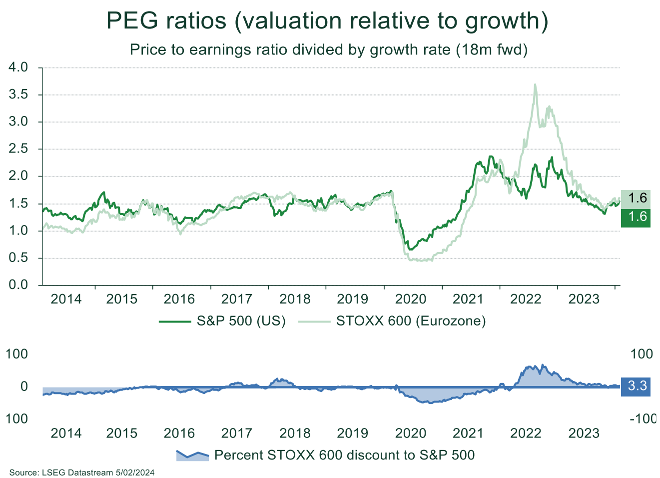
Much of last year's global equity returns can be attributed to the strong performance of the Magnificent Seven companies (Alphabet, Amazon, Apple, Microsoft, Meta, Nvidia and Tesla). So far in 2024 these stocks have continued to outperform broader market indices. The strong performance of these large companies has worried many investors that this narrow performance is unsustainable, and another asset bubble may be brewing.





However, with six of the Magnificent Seven having recently reported their December quarter results, all but Tesla exceeded estimates for revenue. If Nvidia, which is the last to report, delivers on revenue expectations then the Magnificent Seven will have grown revenues 14% over the year compared with 2% for the remaining 493 companies in the S&P 500 index. Profit margins for the Magnificent Seven have also expanded substantially to 23% whereas they contracted for the other 493 companies to 9%.

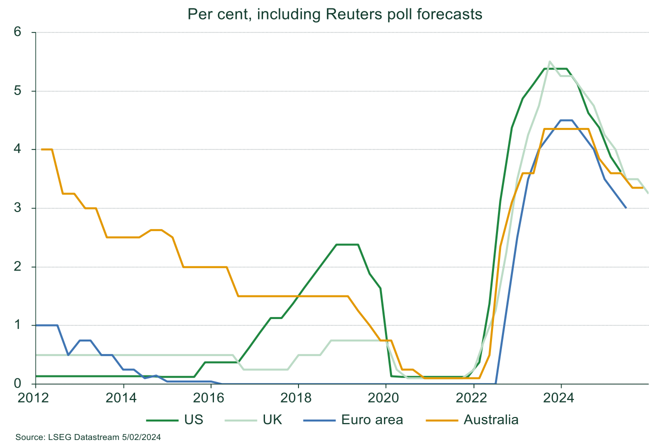
The strong returns for the Magnificent Seven have been driven by earnings growth rather than valuation multiple expansion. Looking at the remaining 493 stocks in the US index and the relative valuation of European stocks, suggest that equity market valuations are reasonable, particularly if interest rates come down and global growth remains intact.




## Fixed income:

The faster-than-expected decline in inflation has provided scope for a reduction in interest rates given overly restrictive monetary policy risks damaging economies by keeping rates too high for too long. There is also a counterbalancing risk that inflation troughs and begins to climb again before sustainably returning to around 2%, especially if rates are cut prematurely. Central banks therefore need to walk this fine line, however, it seems likely that they will have sufficient data and ammunition to justify rate cuts after a few more good monthly inflation reports.

In our view, the outlook for fixed income is relatively balanced with no further rate hikes likely and questions around the speed and size of rate cuts only having a relatively modest impact on longer-dated bond yields. Concerns around government bond supply and demand imbalances, the speed at which central banks shrink their balance sheets and the longer-term neutral rate of interest have subsided. Overall, we view 10-year US treasury yields of around 4% as fair value based on the economic and policy outlook.




## Property and Real Assets:

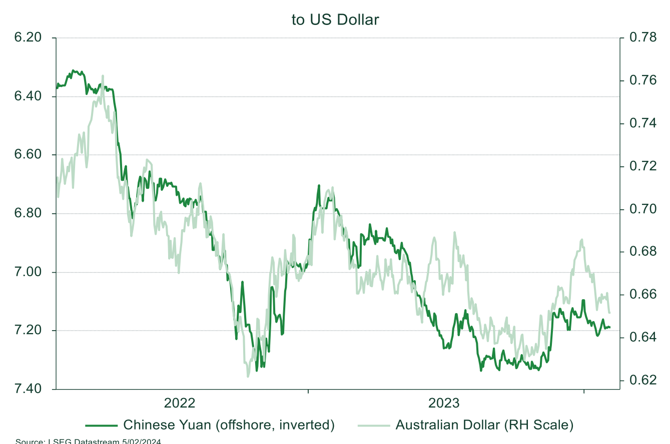
Global listed property and infrastructure gave back some of the strong gains seen late last year as bond yields lifted marginally in January. Based on our expectations that yields should stabilise, we retain a neutral holding in infrastructure and property. Our view remains that listed valuations offer a more attractive entry point into these asset classes and there is scope for listed and unlisted valuations to converge.

## Alternative assets:

Liquid alternative assets posted a return of 0.3% in January (HFRX Global Hedge Fund Index in US$) with long/short equity and macro/CTA funds posting gains while relative value and event-driven funds incurred losses. We remain neutral in alternative assets for portfolio insurance purposes.

## Currency:

The Australian Dollar fell 2.1 US cents in January helped by softer Australian inflation and US Fed officials who dismissed near term rate cut chances. 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 at their peak and rate cuts in late 2024 are looking possible given faster than expected inflation declines in Australia. |
| Australian Debt | Neutral | Retain a neutral weighting with interest rate duration close to benchmark of around five years. Longer term yields are attractive, and risks are evenly balanced given cash rates are at their cyclical peak and are likely to decline later this year. |
| 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 bond volatility to fall as rate cuts come into clearer view. Credit spreads are low, but credit can perform well in a benign economic environment where default rates remain low. |
| Alternative Defensive | Neutral | Alternative strategies generally benefit from higher base 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 but both forces should subside over time. Equity valuations are slightly above average relative to history and 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 still warranted although it is hard to see strong short-term gains continue. Investor focus has shifted from inflation and interest rates to earnings growth which is expected to remain reasonable although growth estimates assume fatter profit margins which may be harder to deliver as inflation declines. |
| Currency hedging | Fully unhedged | Headwinds from interest rate differences between Australia and the US, and a weak Chinese currency are less 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 31 January 2024 | 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 | 7681 | 1.2 | 14.0 | 1.2 | 7.1 | 31.5 | 27.4 |
| Japan - Nikkei 225 | 36287 | 8.4 | 17.8 | 8.4 | 35.6 | 57.1 | 43.3 |
| US - S&P 500 | 4846 | 1.7 | 16.0 | 1.7 | 20.8 | 35.8 | 95.1 |
| US - NASDAQ Composite | 15164 | 1.0 | 18.2 | 1.0 | 32.0 | 17.5 | 117.4 |
| UK - FTSE 100 | 7631 | -1.3 | 4.9 | -1.3 | 2.1 | 30.7 | 32.3 |
| Europe - STOXX 600 | 486 | 1.5 | 12.4 | 1.5 | 10.8 | 30.6 | 57.7 |
| Developed Markets - MSCI World | 2505 | 1.8 | 14.9 | 1.8 | 18.3 | 31.9 | 80.5 |
| Emerging Markets - MSCI EM | 59372 | -3.5 | 5.8 | -3.5 | -0.1 | -15.1 | 19.5 |
| Government bond yields | Change in annual yield in percentage points | | | | | | |
| Australia - 2 year | 3.73 | 0.02 | -0.74 | 0.02 | 0.56 | 3.61 | 1.88 |
| Australia -10 year | 4.05 | 0.09 | -0.89 | 0.09 | 0.49 | 2.95 | 1.81 |
| US - 2 year | 4.23 | -0.02 | -0.84 | -0.02 | 0.02 | 4.11 | 1.76 |
| US - 10 year | 3.95 | 0.08 | -0.96 | 0.08 | 0.42 | 2.85 | 1.31 |
| UK - 10 year | 3.80 | 0.26 | -0.72 | 0.26 | 0.47 | 3.47 | 2.58 |
| Germany - 10 year | 2.16 | 0.13 | -0.65 | 0.13 | -0.12 | 2.68 | 2.01 |
| Currencies and Commodities | Change in price | | | | | | |
| Australian Dollar (US$) | 0.6611 | -0.021 | 0.028 | -0.021 | -0.044 | -0.106 | -0.068 |
| US Dollar Index | 103.27 | 1.94 | -3.39 | 1.94 | 1.18 | 12.69 | 7.69 |
| Gold (US$/ounce) | 2053.25 | -15.42 | 56.35 | -15.42 | 129.35 | 189.45 | 730.00 |
| Iron Ore (US$/tonne) | 131.85 | -8.81 | 10.65 | -8.81 | 4.22 | -26.92 | 47.34 |
| Crude oil (WTI, US$/barrel) | 76.28 | 4.39 | -5.34 | 4.39 | -2.59 | 24.10 | 22.49 |

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