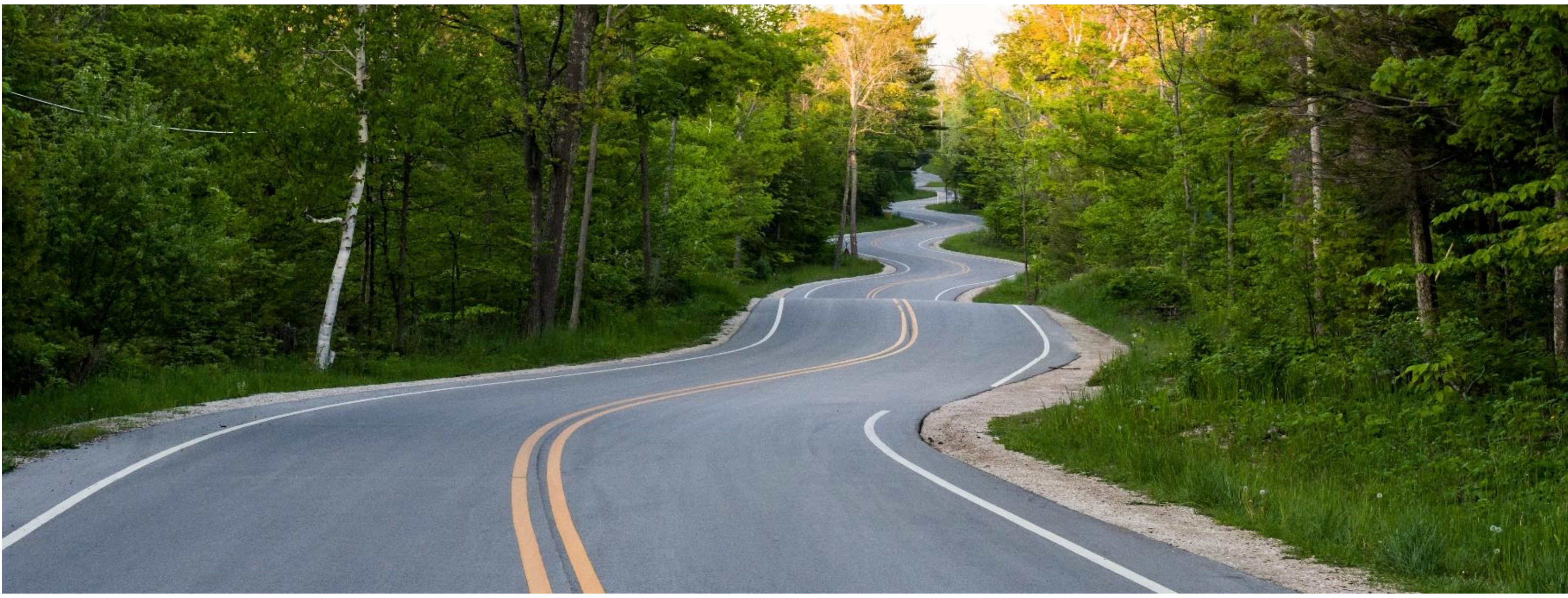


5 March 2024

Investment Markets Report

Nick Ryder – Chief Investment Officer

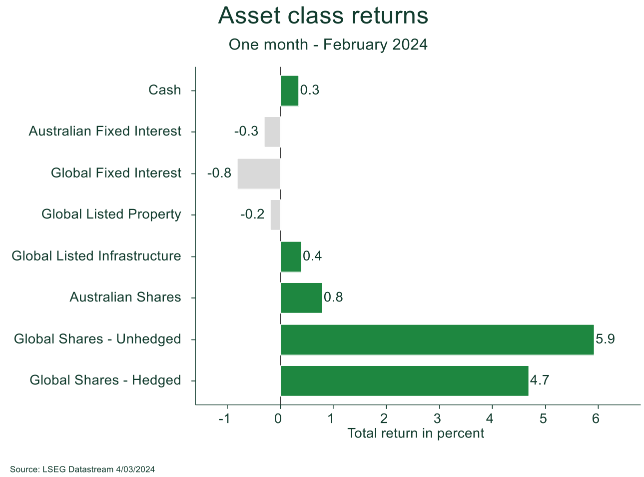
Our investment office unpacks what happened in the past month, current tactical positioning and what this means for our portfolio weightings to different asset classes.

What's changed in February?

Global equity markets continued to rally in February, helped by investor optimism about the US economic outlook and the solid US earnings reporting season, which showed that large capitalisation technology companies are continuing to grow strongly. This came despite signs that the decline in inflation has stalled recently, which prompted central banks to caution investors against expecting rate cuts in coming months. Reduced probability of near-term interest rate cuts saw bond yields rise in February, but the equity market is now focussed on the growth outlook and less concerned with higher inflation and bond yields.

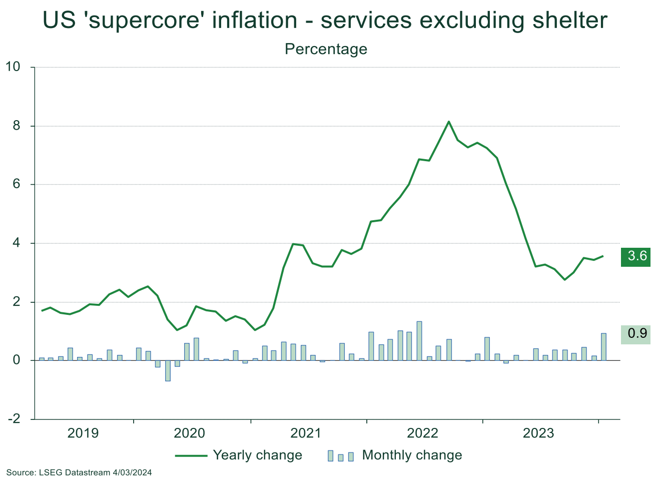
- In currency-hedged terms, developed market equities (MSCI World ex-Australia) rose 4.7% in February. Emerging market shares (MSCI Emerging Markets) gained 5.1% as Chinese stocks rebounded. Australian shares (S&P/ASX 200) returned 0.8%.
- 10-year government bond yields rose 10 basis points (bps) in Australia, 30bps in the US, 24bps in Germany. 33bps in the UK while they fell 2bps in Japan.
- Investment-grade corporate bond spreads in the US narrowed by 2bps to 100bps over US treasuries while US high yield bond spreads fell by 20bps to 329bps.
- The Australian Dollar fell 1.0 US cent to US$0.6512.
- Oil prices rose 3.9% to US$79.22 per barrel (WTI). Gold fell 0.3% to US$2,048 per troy ounce. Iron ore prices fell 12.3% to US$114.57 per tonne.

Asset class returns – February 2024



Tactical Positioning

In our view, the global disinflation story remains largely intact even though the last kilometre on the road back to 2% annual inflation is going to be harder to navigate. While energy and goods prices continue to either fall or decelerate, services inflation has remained sticky as we have highlighted previously. This saw inflation move higher in the US and Eurozone in January, partly due to seasonal factors such as companies putting through annual price rises in the new year.



The global economic picture is somewhat patchy, with the US economy resilient but Europe and Japan are already in, or close to, recession, and Chinese growth remains weak. The Australian economy has been resilient at a top line level, supported by population growth and export volumes, but is in recession on a per capita basis. Despite mixed economic performance, labour markets in most countries are generally holding up, as companies are reluctant to let workers go given fresh memories of labour shortages.

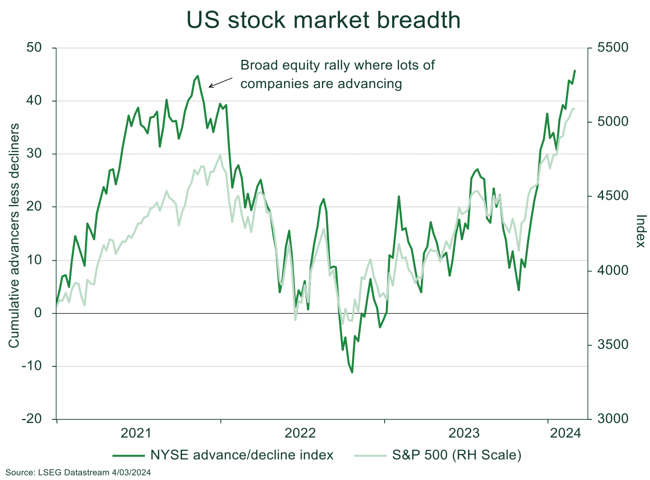
Central bankers have continued to talk down prospects for near term rate cuts given sticky services inflation and robust labour markets. The message is that they want to gain more comfort that inflation is heading sustainably back to 2%. The economic backdrop provides time for policymakers to wait for further declines in inflation or signs of labour market weakness before cutting rates. Most estimates are that the preconditions for the first-rate cuts in the US and Eurozone could be met in June and August/September in Australia.

The precise timing of rate cuts has not really been a big influence on equity markets, given inflation and interest rates are likely to fall from here and this should support further improvement in both economic and earnings growth. For bond investors, worries about higher-for-longer interest rates and demand/supply imbalances in government bond markets, have eased, and so far in 2024, we have seen demand for bonds step up to meet the large volume of new issuance.

We continue to maintain a neutral risk position in portfolios with a neutral weight to growth assets such as equities. While some commentators continue to worry about a US recession, when consumers fully deplete excess savings and companies are forced to cut staff to protect earnings, we see recession risks as only being marginally higher than in an average year. Risks around the November US election are also overstated in our view, given the experience with past elections (including 2016 and 2020) with markets often rallying as uncertainty fades and future policy changes get priced in.

Equities:

The rise in equity market since October has pushed valuation multiples to levels reached in the euphoria of 2021 when interest rates were expected to remain low for a long time. This time around, the higher valuations are concentrated in the largest Magnificent Seven (Mag7) stocks and investors have now adjusted to the higher cost of capital. Outside the Mag7, valuations for lower growth and smaller companies are subdued, unlike in 2021 where low quality, often unprofitable "growth at any cost" companies rose to excessive levels.



While there is scope for the Mag7 stock prices to run out of steam at some point, for now the valuations appear justified and timing turning points can be difficult and will largely depend on how long the artificial intelligence spending boom continues. We do see scope for equity markets to continue to rise, supported by a broadening of performance into those countries, sectors and companies left behind by the Mag 7 gains as investors hunt for future winners and better value.

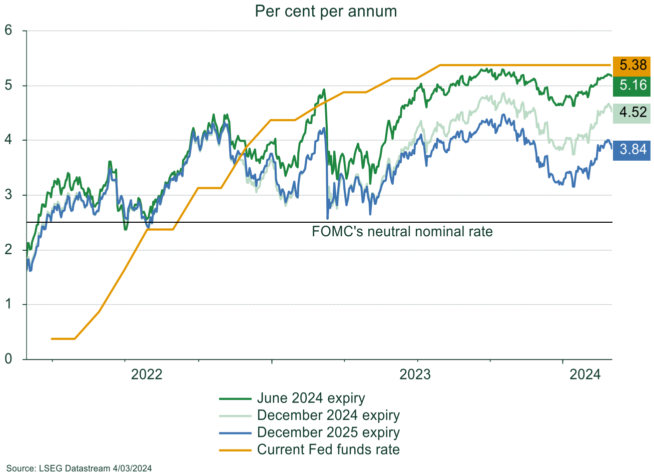
Australian earnings reporting season was in line with historical averages as 40% of companies in the S&P/ASX 200 beat earnings estimates for the half year. Revenues slowed, but a focus on costs supported earnings for those companies that beat earnings estimates. Companies exposed to discretionary consumer spending gained 11% in February on hopes of a turnaround flowing from potential interest rate and tax cuts, despite reporting weaker sales trends.

Fixed income:

As discussed, central banks have succeeded in shifting expectations away from rapid and significant rate cuts this year. Markets have got the message that rate cuts are more likely to begin in mid-2024 and that they will be minor and gradual adjustments to shift policy rates from restrictive to neutral settings. Current pricing shows three to four rate cuts in the US and Eurozone this year, starting in June and assuming no shocks to growth or inflation this seems fair.

US Federal Reserve funds rate futures

Per cent per annum



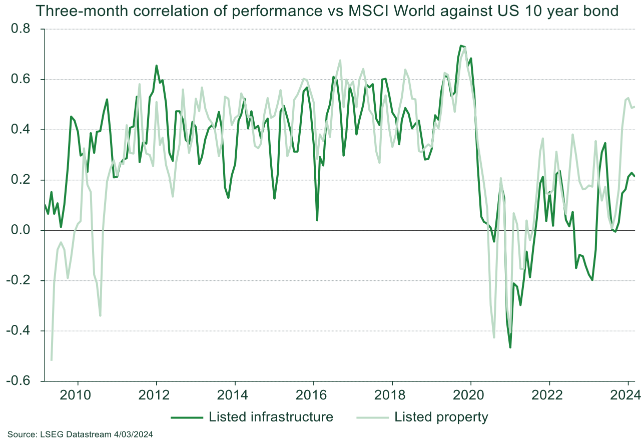
As interest rates come down in the second half of 2024, we expect yield curves to steepen as longer-term bond yields remain range bound at around current levels. A steeper yield curve will make it more attractive for investors to own interest rate duration (i.e. longer maturity fixed rate bonds) and capture the premium and additional returns from 'rolling down' the yield curve. This occurs when higher-yielding longer term bonds gradually become lower-yielding shorter term securites as they get closer to maturity.

Property and Real Assets:

Global listed property and infrastructure did not participate in February's equity market gains due to higher sensitivity to rising bond yields. Property valuations continue to reset lower as more asset sales provide evidence for property valuers, although lower interest rates should place a floor under values at some point. We view listed property and infrastructure as a more attractive entry point into these asset classes, given they trade at large discounts to current values.

Correlation with US bond yields

Three-month correlation of performance vs MSCI World against US 10 year bond



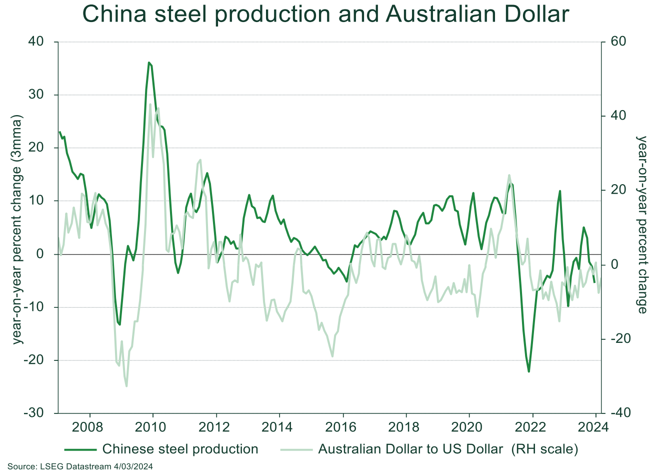
Alternative assets:

Liquid alternative assets posted a return of 0.9% in February (HFRX Global Hedge Fund Index in US$) with long/short equity and macro/CTA funds posting the largest gains ahead of relative value and event-driven funds. We remain neutral in both defensive and growth alternative assets.

Currency:

The Australian Dollar fell 1.0 US cent in February helped by further repricing of near-term US and local rate cuts and ongoing economic softness in China. We prefer global share exposures remain currency-unhedged given high hedging costs and the diversification benefits from currency moves.

China steel production and Australian Dollar



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 the ongoing decline in Australian inflation.
Australian Debt	Neutral	Retain a neutral weighting with interest rate duration close to benchmark of around five years. Longer term yields are more 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 six to seven years. We expect bond volatility to fall as rate cuts commence in mid-2024. Credit spreads are low and are unlikely to tighten much further, but credit can perform well in a rate cutting environment that should keep default rates from rising.
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 due to higher bond yields, 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 modest bank profit growth, derating of major healthcare stocks and limited Chinese stimulus. Earnings reporting season did not provide too many surprises with some modest upgrades to full-year earnings, as is typically the case. Equity valuations are slightly above average relative to history and dividend yields are not 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. Investor focus has shifted from inflation and interest rates to economic and corporate earnings growth which remains reasonable and ultimately drives equities higher. A pause or minor correction is overdue given the unusually long uninterrupted rise in equity markets in recent months.
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 29 February 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	7699	0.8	9.4	2.0	10.6	30.7	39.1
Japan - Nikkei 225	39166	8.0	17.2	17.1	45.7	57.1	43.3
US - S&P 500	5096	5.3	12.0	7.1	30.5	38.0	99.1
US - NASDAQ Composite	16092	6.2	13.3	7.3	41.6	22.6	122.9
UK - FTSE 100	7630	0.5	3.0	-0.8	0.8	30.5	30.0
Europe - STOXX 600	495	2.0	7.5	3.5	10.9	32.2	54.4
Developed Markets - MSCI World	2617	4.6	11.0	6.5	25.7	34.3	82.7
Emerging Markets - MSCI EM	62319	5.1	4.7	1.5	10.1	-10.6	24.2
Government bond yields	Change in annual yield in percentage points						
Australia - 2 year	3.74	0.01	-0.37	0.03	0.07	3.62	2.02
Australia -10 year	4.15	0.10	-0.24	0.19	0.28	2.30	2.05
US - 2 year	4.63	0.40	-0.08	0.38	-0.17	4.48	2.11
US - 10 year	4.24	0.30	-0.10	0.38	0.33	2.79	1.53
UK - 10 year	4.12	0.33	-0.05	0.58	0.30	3.30	2.82
Germany - 10 year	2.40	0.24	-0.04	0.38	-0.23	2.66	2.22
Currencies and Commodities	Change in price						
Australian Dollar (US$)	0.6512	-0.010	-0.012	-0.031	-0.023	-0.123	-0.060
US Dollar Index	104.16	0.88	0.66	2.82	-0.71	13.28	8.00
Gold (US$/ounce)	2048.05	-5.20	12.60	-20.61	223.45	305.20	728.90
Iron Ore (US$/tonne)	114.57	-16.00	-16.56	-25.35	-9.48	-58.14	31.14
Crude oil (WTI, US$/barrel)	79.22	2.94	3.61	7.33	2.27	15.69	22.00

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