MARKET AND ECONOMIC UPDATE

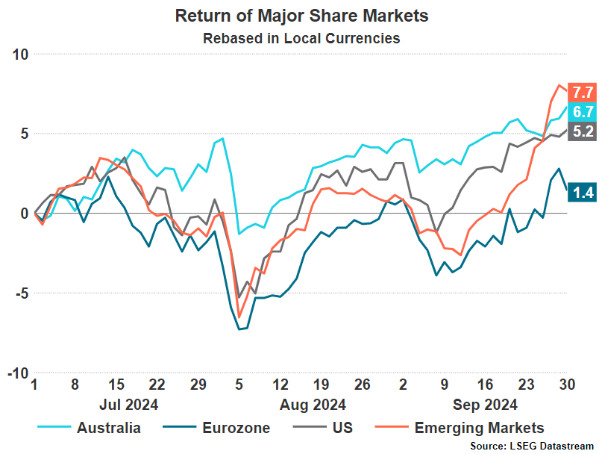
September Quarter 2024

KEY POINTS

- **Equity All-Time Highs:** Despite volatility caused by a spike in US unemployment and an unexpected rate hike in Japan, global equities continued to rise in Q3 2024, with many major equity markets reaching all-time highs. This increase occurred off the back of continued excitement around A.I. and NVIDIA as well as the global trend of falling interest rates, most notably in the U.S. which cut rates for the first time this cycle in September.
- **U.S. Rate Cut in September:** The US Federal Reserve cut rates for the first time since they started hiking in 2022. A rate cut should mean that the economy is showing weakness, but the market did not react this way, instead equities rallied on the rate cut news. This has raised concerns that in a slowing rate environment equities may run out of steam.
- **Bond Prices Rose Off Both Real and Expected Rate Cuts:** Over the quarter both global and Australian bonds rose as central banks continued to cut rates globally and Australia comes closer to its first rate cut, which we expect to occur in 2025. Global bond yields fell following the 50bp rate cut in the US which also provided a tailwind to fixed income markets.
- **Australian Dollar appreciates:** The AUD appreciated against the USD as the Federal Reserve cut rates while the RBA continues to wait for the Australian economy to slow further. The USD depreciated against a number of major currencies as decreasing the central bank rate lowers the risk-free return that investors can receive from holding USD relative to other currencies.
- **Cautious Q4 Outlook:** We expect to see market volatility in the fourth quarter of 2024, especially following the U.S. election. For portfolios we recommend using diversified equities across both regions and investments styles and for fixed income we recommend a medium duration approach to benefit from rate cuts while hedging against an unexpected resurgence in inflation.
- **Sector Performance:** Performance in the third quarter of 2024 was found across a broader range of sectors than previous quarters as we saw some rotation away from technology stocks and into more defensive sectors and small cap stocks that had been neglected earlier in the year.

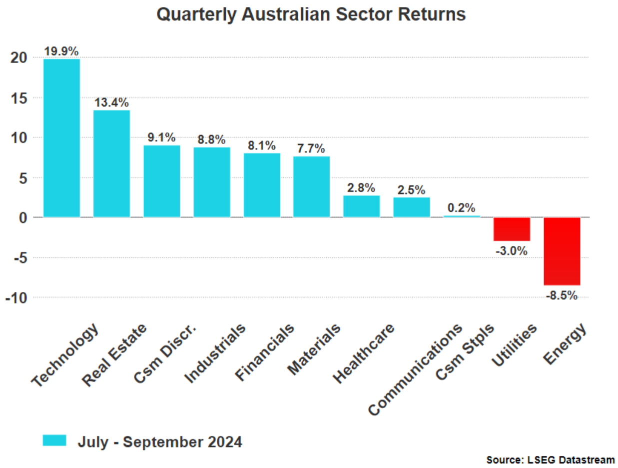
1. MARKETS IN REVIEW

Following COVID, rampant inflation swept across the globe causing Central Banks to aggressively hike interest rates. After US central bank rates hiked to 5.5% in July of 2023 markets have finally received a long-awaited rate cut in September, as Jerome Powell cut US interest rates by a generous 50bps. Although much of this rate cut was already priced in, markets generally performed well in Q3, minus a short-lived drawdown in early August caused by the Bank of Japan raising interest rates, and a spike in US unemployment. The standout performer over the period was Emerging Markets which was driven by China announcing fresh stimulus in a hope to reignite the economy.



Fixed income markets were a major beneficiary of the September rate cuts which resulted in the US 10-year Treasury yield declining by 49bps. A global trend of falling inflation and subsequently falling interest rates in many developed markets meant that positive fixed income performance was not isolated to the US, and solid returns were seen globally. This is highlighted through the Global Aggregate Bond Index which returned 7% over the quarter. Australia also saw gains in fixed income as investors await signs that the RBA will begin to cut the cash rate.

2. EQUITIES

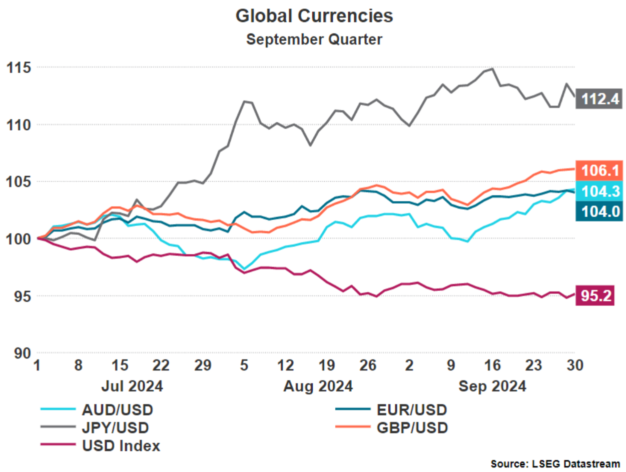


Australian equities finished the quarter in positive territory, but that is not to say there was not volatility along the way. In early August, an unexpected spike in US unemployment to levels not seen for almost three years sparked fears of a US recession and led to a selloff in equity markets. Coinciding with this, the Bank of Japan unexpectedly hiked rates causing an unwinding of a popular trading strategy known as the 'carry trade'. The premise of the strategy is to borrow from a country with a low interest rate and invest in higher yielding assets. In practice, Japan have historically had very low interest rates making the Yen a target for traders to borrow from, whilst the US market has an abundance of high yielding assets. When the BOJ hiked rates, many investors were forced to unwind this trade, further exasperating the global sell off in the US. Despite this, the sell-off was short lived with markets rebounding beyond pre-sell off levels in a matter of days.

Australian Technology continued to perform well over the third quarter with year-to-date returns now at an impressive 48.53%. Similarly Real Estate also performed well, gaining 13.4% over the period as investors look towards rate cuts and continue to benefit from strong housing demand. On the other hand, Energy struggled amid OPEC revising down its forecasted demand for the remainder of this year and 2025.

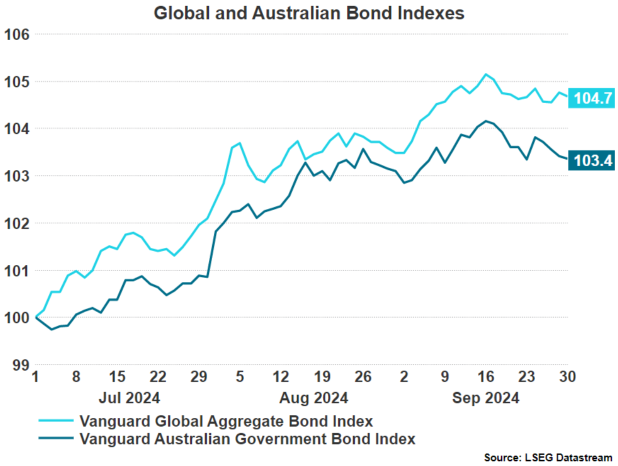
3. FOREIGN EXCHANGE MARKETS

Over the quarter there was volatility in Foreign Exchange Markets, most notably between Japan and the US. As previously mentioned, the Bank of Japan unexpectedly hiking interest rates caused a rapid appreciation in the Yen as demand for the now higher yielding currency rose. The result of this was JPY/USD rising by a huge 12.4% over the third quarter. The large move was exacerbated by a fall in the US dollar as rates were slashed by 50bps. A fall in rates caused investor demand to dampen as the opportunity cost for holding USD over another, higher yielding currency increased.



The Australian Dollar rose modestly over the third quarter, as the uncertainty continued surrounding when the RBA will cut rates leading to investors pricing in higher rates for longer. This is especially the case in comparison to many of its counterparts who have now begun their rate cutting programs, such as the US resulting in AUD/USD appreciating by 4.3%.

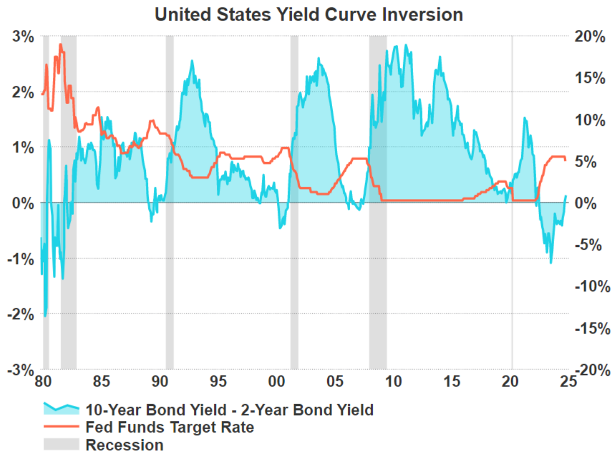
4. FIXED INCOME MARKETS



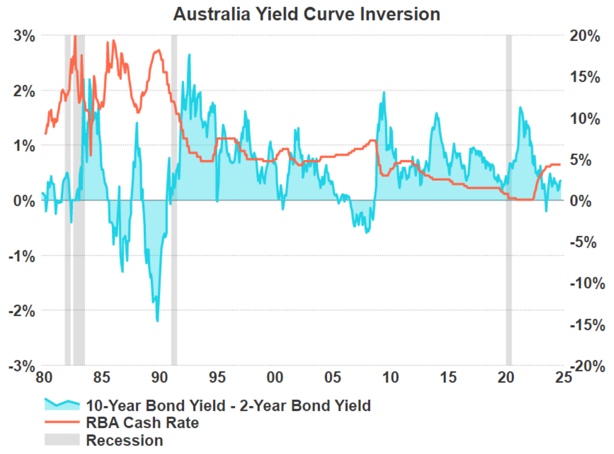
Fixed income markets rose over the third quarter as yields generally fell amid central banks beginning or continuing their rate cutting programs. As we know, bond prices rise as yields fall and therefore the Global Aggregate Bond Index appreciated by 4.7%. This was led by the US where 2-year yields fell by 111 bps over the period. Yields in Europe followed suit and declined as the European Central Bank cut rates by 25bps.

Australian fixed income also performed well in Q3 as investors look towards rate cuts. Although headline CPI appears to be coming down in Australia, much of this reduction was due to government subsidies put in place to lower energy costs. If we remove this aspect, the overall inflation trend remains a slow-moving downwards trend and therefore the RBA is keeping rates on hold. Despite sticky inflation, the slowing economy and persistent elevated unemployment rate is spurring on investor belief that the RBA will have to soon cut rates. As a result, yields fell over the period lifting bond prices.

The US has recently un-inverted its yield curve. The inversion was the longest and deepest by far in the last 40 years. A yield curve inversion is a common recession indicator in the US with every inversion in the past 40 years being followed by a recession. This recession usually comes 12 months after the un-inversion and therefore we must wait and see over the next period whether the indicator continues to correctly predict economic trends.



The Australian yield curve has normalised for quite some time now, but we are still waiting to see whether Australia will enter a recession or narrowly avoid one as inflation slows. However as previously mentioned with such sticky inflation, the RBA must correctly time rate cuts in order to avoid a recession.



5. OUTLOOK

As we know, financial markets are forward looking. Markets are currently priced for a soft landing and therefore even a mild recession could cause a significant downturn in markets. Looking ahead to the remainder of the year we think a cautious approach should be taken in markets. Data releases suggesting an aggressive slowdown of the economy is likely to weigh on investor sentiment and cause volatility. Although we think a soft landing is still possible, we believe that markets are being too optimistic, and the chance of a recession is more likely than what is currently priced in.

Having received a 50bp rate cut in September and markets currently pricing in a further 50bps of cuts by the end of the year, there is likely to be a tailwind for equities. Small and mid-cap companies are likely to benefit from the fall in rates however picking quality companies in this space is likely to bode well should we see the macroeconomic backdrop decline. Going forward we also think that due to the excitement surrounding the A.I. revolution, these names are likely to continue to perform well in the long run. However, with valuations stretched it is important to manage these positions in a portfolio. NVIDIA is a prime example of a great business with stretched valuations, with such ambitious revenue targets we believe it is only a matter of time before these results fall short.

Fixed income is also likely to perform well as rates decline. Despite yields having already fallen it is important to remember that income remains attractive and at levels not seen for many years. We are positive on government bonds which allows exposure to duration which will perform well with rates declining, as well as safety which will become sought after should the macro environment decline. Credit offers attractive yields; however, a selective approach should be implemented, especially in the high yield market in order to reduce risk from a rise in defaults in a downward market. Overall, a selective approach with a medium to long term duration is likely to bode well going forward in the current market environment.

Alternatives may be used in portfolios to improve diversification. Short term spikes in volatility gives opportunity to hedge fund type strategies which can capitalise on these moves. Private markets may also be used for protection against short term market swings. Lastly, metals can also be used as a hedge against inflation whilst also benefitting from being a safe haven during periods of geo-political tension. Gold typically has an inverse relationship with treasury yields and subsequently provided a further tailwind for the metal, causing it to reach all-time highs in the third quarter.