Economic & Investment Update - January 2024

October saw equity markets continue their decline as stubborn inflation, rising bond yields, tentative company earnings outlooks and ongoing geopolitical tension took their toll. The US and UK Central Banks continued their "restrictive" interest rate policies in order to tame inflation, with investors fearing interest rates would remain higher for longer.

However, markets and economies pivoted in November with the release of US October inflation numbers. Annual inflation fell to 3.2% as energy costs fell and food, housing and used car costs moderated. A further decline to 3.1% in US November inflation saw the US Federal Reserve indicate a clear willingness to reduce interest rates in 2024. Equity markets reacted very positively given the Federal Reserve median expectation for a 0.75% decrease in interest rates over the 2024 calendar year. Despite concerns of a potential hard landing, the US economy displayed some resilience with unemployment staying low at 3.7% and consumer sentiment rising off the back of an improvement in the inflation outlook.

Australian and Global bond markets reacted positively over November and December. After a rise in bond yields in October, the 10-year bond yield contracted by around 1% in Australia and overseas.

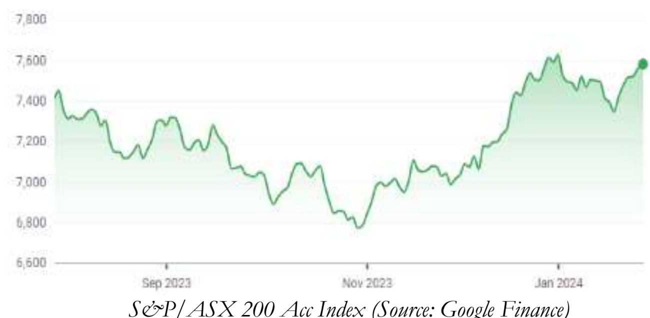
Annual inflation in the Euro area fell to 2.9% in December, however, unemployment remained high at 6.4% amid a deterioration in economic conditions. The ECB kept interest rates on hold at 4.5%. In the UK, annual inflation fell from 6.7% down to 4.0%, prompting the Bank of England to keep the cash rate on hold at 5.25% in the face of a deteriorating economic landscape.

Headwinds in the Chinese real estate sector continued to apply a handbrake to their post-COVID economic recovery. China's GDP grew by an annualised rate of 5.2% over the December quarter, slightly below market expectations. However, this was accompanied by unemployment remaining high at 5.1% and deflation over the quarter.

In Australia, the newly appointed head of the RBA (Michele Bullock) kept cash rates on hold at her first meeting before raising them by 0.25% to 4.35% at the November meeting, as inflation proved more persistent than expected (4.3% at November). As a consequence, the Australian dollar appreciated by 5.9% over the quarter against the US dollar while the International Monetary Fund (IMF) recommended that the RBA lift interest rates further, to curb inflation.

MARKETS

In Australia, the S&P/ASX 200 Accumulation Index returned 8.4% over the December quarter. The Health Care sector rose 13.3%, driven by strong returns from CSL, Resmed and Cochlear. Robust gains in the price of iron ore and other commodities pushed the Materials sector up 13.2% over the quarter. Energy stocks were hit by a fall in oil prices, partly due to a struggling Chinese economy beset by falling demand for goods from overseas markets. As such, the Energy sector retreated by -9.0% over the quarter.



S&P/ASX 200 Acc Index (Source: Google Finance)

Smaller ASX-listed companies (top 100-300) returned 8.5% for the quarter, in line with the return of the S&P/ASX 200 Accumulation index.

Global equity markets rebounded over the December quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) up 9.2%. With the Australian Dollar strengthening, unhedged investment returns were not as buoyant, finishing up 5.3%.

Developed markets ended higher with the broad-based US S&P 500 PR Index the strongest, up 11.2% over the quarter driven by "the Magnificent Seven (Apple, Amazon, Alphabet / Google, Meta / Facebook, Microsoft, NVIDIA and Tesla)". After a drop of -3.7% over the previous quarter, the German equity market (as measured by the Deutsche Boerse DAX 30 PR Index) rose 8.9%

In stark contrast, with China struggling to post a strong Covid economic recovery, Chinese shares (as measured by the Shanghai Shenzhen CSI 300 Index) were down 7.0% for the quarter. The Hong Kong Hang Seng PR Index was down 4.3%.

The property sector reacted positively to the Fed's dovish tone with Australian listed property up 16.6% for the December quarter and global property securities up 12.7%.

The Fed's dovish tones also lead to a sharp rally in the bond market. Against this backdrop, the Bloomberg AusBond Composite Index gained 3.8% over the quarter while the Bloomberg Global Agg TR Index (AUD Hedged) was up 5.4%.

The table below (sourced from Lonsec) summarises the returns from a number of market sectors.

Sector	Index	3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	S&P/ASX 200 TR (Accumulation) Index	8.4	12.4	10.3
	S&P/ASX Small Ordinaries TR (Accum) Index	8.5	7.8	6.4
International	MSCI World ex Aust NR Index (AUD)	5.3	23.2	13.6
	MSCI World ex Aust NR Index (AUD Hedged)	9.2	21.7	11.6
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	2.0	9.2	4.3
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	16.6	17.6	6.1
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	12.7	7.9	1.9
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	8.1	4.4	6.5
Currencies				
AUD v USD	Against US Dollar	5.9	0.0	-0.7
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	3.8	5.1	0.6
	Bloomberg Ausbond Credit All Maturities	3.2	6.8	2.0
International	Bloomberg Global Agg TR Index (AUD Hedged)	5.4	5.3	0.5
Commodities				
Gold	Gold – USD	11.6	13.1	10.0
Oil	WTI Oil $/b – USD	-21.1	-10.7	9.6

OUTLOOK

With inflation in the US and Europe down to around 3%, markets are now forecasting falling interest rates over 2024. Previously, interest rate adjustments have been predicated on taming rampant inflation however, moving into 2024, Central Banks will be more cognisant of the impact on faltering economies and the desire to avoid, or at least limit, the impact of recession.

However, there are many diverging trends both between and within economies. Gross Domestic Product (a measure of economic growth) in the US is expected to come in around 2.7% for the 2023 calendar year, a rise from 0.7% in 2022. However, other data such as Gross Domestic Income and forecast corporate profits indicate a faltering economy. This may lead to a hastening of interest rate reductions.

The Australian economy has been relatively robust post Covid, however GDP is now falling in stark contrast to the US. Furthermore, inflation in Australia remains stubbornly high with calls from the IMF for a further interest rate rise. Given Australia's lag in taming inflation, financial markets have only factored in a 0.5% fall in Australian interest rates as opposed to a 1.5% reduction in the US.

Although inflation in Europe is projected to fall to 2.7% over 2024, it is at the cost of a recession. Germany, the economic powerhouse of Europe, entered recession in 2023 amid higher energy prices and lower demand for its products. Other European countries have followed. Consequently, markets are factoring in a 2.0% fall in interest rates. The UK are yet to tame inflation and are on the brink of a recession amid a deteriorating economic landscape.

In stark contrast, China is currently suffering deflation (falling prices) amid a growing economy with GDP at 5.2% for the December quarter. However, the reality is that the country is struggling to bounce back out of its prolonged Covid lockdowns with unemployment remaining high at 5.1% and weakening internal and external demand.

Albeit at different rates, the expectation is for global interest rates to fall over 2024. This has already been factored into the financial markets and was the main reason for the recent "santa rally". As we head into 2024, financial markets still have to come to grips with ongoing political issues including global conflicts and the upcoming US election.

Our views on the various asset classes are outlined below.

Australian Equities

Within Australian Equities, we recommend investors retain a neutral to underweight positions in large cap stocks and smaller companies.

Market conditions are softening with 2024 corporate earnings expected to decline versus 2023. Given the recent "santa rally", investors should be wary about buying into a market that is trading slightly above long-term valuations. Indeed, for those who have moved into an overweight position, now may be an opportune time to take some profits.

Within portfolios, preference should continue to be towards sectors that are well insulated from downgrade risk and able to weather macroeconomic headwinds and rising borrowing costs. In relation to smaller companies, these are usually more economically sensitive and fears of a credit crunch is not favourable for smaller company earnings expectations.

International Equities

With the outlook for equity markets remaining challenging, we recommend investors retain a neutral to underweight position to International developed markets. Despite the weakness out of China, we recommend investors move to a neutral exposure to emerging market economies.

Global equity valuations appear more stretched, particularly in the US. However, a closer analysis demonstrates the dichotomy of the US market. The Magnificent 7 (Apple, Amazon, Alphabet / Google, Meta / Facebook, Microsoft, NVIDIA and Tesla) were recently trading on a PE multiple of 28x with average forecast earnings growth of 44%, whereas the remainder of the S&P500 were trading on a multiple of 17x with average forecast earnings growth of -3.3%

Emerging market valuations now look attractive with much of the bad news around China priced in. Further Government stimulus in China should help support markets.

Property

We recommend investors retain a neutral to underweight position to Australian property and move to a similar position to International property.

Share prices have recently bounced off the back of falling bond yields. Investors should be wary about buying into a market that has recently rallied, albeit that bond yields could weaken further. We maintain a negative view on office space and the retail sector, positive views on industrial property and are neutral on the healthcare sector.

Similar dynamics are at play in global property hence we now recommend neutral to underweight exposure to this sector.

Fixed Interest

Following recent falls in yields, Australian and International sovereign bonds are now trading close to fair value. Government bonds currently offer a reasonable coupon rate and historically have provided investors with a hedge against share market volatility. However, should bond yields rise, Australian and International sovereign bonds are at risk of further capital falls.

While not offering a similar hedge against share markets, higher rates continue to be available from term deposits.

Bank hybrids offer a strong return, albeit with some risk given their correlation to equity markets. Yields on corporate bonds look reasonable on face value but carry increased risk in the event of an economic downturn and credit contraction.

Alternatives

We retain a neutral setting for Infrastructure investments despite the recent rally off the back of falling bond yields. Private Equity investments are expected to continue to be well supported, underpinned by strong returns, however now is a good time to take profits and move towards a neutral position.

In this climate of market uncertainty, we continue to support an allocation to gold or silver in diversified portfolios. Exposure to gold, either through gold producers or via an investment in physical gold, as well as physical silver, through ASX listed entities, provides additional diversification within portfolios and some protection against ongoing inflation.

Sources: Lonsec, Schroders. Please note that the information above is general in nature and does not take into account your personal circumstances, financial needs or objectives. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation and needs. In particular, you should speak to Kevin Smith of The Professional Super Advisers on (02) 9955 5800 prior to acting upon this information.