Economic & Investment Update - July 2024

The June quarter was marked by a significant level of activity on the political front. The calling of snap elections in both France and the UK backfired as the incumbents lost power to the left. Across the other side of the Atlantic, the odds continue to shorten on Donald Trump becoming the next President. If elected, this may lead to prolonged inflation given the likely continued high spending, potential tax cuts and the imposition of import tariffs. It may also lead to increased upside risk in respect of current global conflicts.

In April, we noted that with core inflation falling more slowly than expected in many developed economies, investors are now adjusting to an environment where inflation and interest rates are likely to remain 'higher for longer'. This had already spilled over into investment markets during April with bond yields rising sharply, equity markets pulling back from record highs and precious metal prices ballooning.

In the US, annual inflation fell to 3.0% in June as inflation eased for energy shelter and transportation. The Federal Reserve have kept the target range for the federal funds rate unchanged at 5.25% - 5.50% with policymakers unlikely to reduce rates until there is greater confidence that inflation is moving sustainably towards 2%. The current expectations are for a drop in rates at their September meeting. The unemployment rate rose slightly from 4.0% to 4.1% as the participation rate increased.

In Europe, economic growth has slowed much faster with a deep contraction in manufacturing output and unemployment at 6.4%. The inflation rate eased to 2.5% in June with the European Central Bank cutting official interest rates by 0.25% to 4.25% at its June meeting. In the UK, the Bank of England left rates unchanged at 5.25% with the inflation rate for May coming in at 2.0% in line with the target rate.

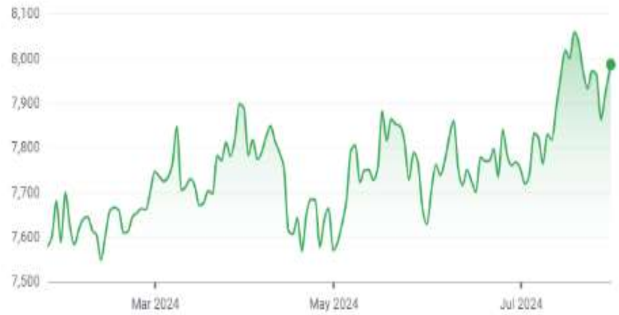
In Australia, rates were left unchanged at 4.35% however the chances of a rate rise in the coming months increased as annual inflation rose to 3.8% in June, stubbornly above the 2-3% target range. Retail sales were up by 1.7% for the year however this is due to the rate of inflation rather than the purchase of more goods. Unemployment fell to 4.0% in April.

In Japan, inflation rose to 2.8% in May, overshooting the market forecast of 2.5%.

In China, inflation has yet to take hold, dropping 0.1% in May to 0.3%. Other market indicators were marginally positive with growth in the manufacturing sector and a rise of 3.7% in annual retail sales to May. However, the post Covid boom is yet to materialise with unemployment remaining flat at 5.0%.

MARKETS

In Australia, the S&P/ASX 200 Accumulation Index was down 1.1% over the June quarter. Utility stocks generated the best sector return, up 13.3%. However, ongoing weakness in China and falling iron ore prices resulted in falls in the Energy (-6.7%) and Materials (-5.9%) sectors for the quarter.



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

Smaller ASX-listed companies (top 100-300) returned -4.5% for the quarter, underperforming the return of the S&P/ASX 200 Accumulation index.

Global equity markets continued to rally in the June quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) up 3.0%. With the Australian Dollar strengthening, unhedged investment returns were reduced to 0.3% for the quarter.

Developed markets generated variable returns with the Hong Kong Hang Seng being the best performer, up 7.1%. The Taiwanese market was the best performer in the Asia Pacific region for the half year with the index up 28.5% boosted by Taiwan Semiconductors which gained 63%.

However, as with Australia, the small cap stocks struggled with the MSCI World Small Cap NR Index AUD falling 5.0%. The Japanese market as measured by the Nikkei 225 PR index gave up some of its recent gains, down 4.9% in April and 2.0% for the quarter as global interest rate concerns hit the tech sector. The Chinese markets also struggled, with the Shanghai Shenzen CSI 300 PR index down 2.1% over the quarter.

The Australian property market, as measured by the S&P / ASX 200 A-REIT Accum Index regressed in April for the first time this year, with the index down 7.8% as markets reacted to the higher for longer interest rate scenario. However, the index recovered slightly to be down 5.6% over the quarter. Global property securities fared slightly better, down 2.0% for the quarter.

April saw a tough month for bond markers, both locally and internationally, with yields back at levels last seen in December 2023. Markets then recovered slightly but were still down over the quarter.

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	-1.1	12.1	7.3
	S&P/ASX Small Ordinaries TR (Accum) Index	-4.5	9.3	3.7
International	MSCI World ex Aust NR Index (AUD)	0.3	19.9	13.0
	MSCI World ex Aust NR Index (AUD Hedged)	3.0	20.2	11.0
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	2.6	12.2	4.1
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	-5.6	24.7	4.4
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	-2.0	4.6	-1.1
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	2.6	6.8	3.8
Currencies				
AUD v USD	Against US Dollar	2.3	0.1	-1.0
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	-0.8	2.5	-0.6
	Bloomberg Ausbond Credit All Maturities	0.2	6.1	1.2
International	Bloomberg Global Agg TR Index (AUD Hedged)	-0.2	2.7	-0.7
Commodities				
Gold	Gold Spot Price – AUD	1.9	20.8	11.6

OUTLOOK

Global macroeconomic forecasts and forward-looking macroeconomic data suggest a positive but muted economic outlook. The consensus GDP forecasts for the G7 remains at around 1.6% – 1.7% for 2025 and 2026. Furthermore, the Services and Manufacturing Purchasing Managers' Index (PMI), being a survey of businesses regarding economic indicators, continue to improve. This is most notable in Europe but also in the US. Europe is anticipated to move out of its recessionary-like conditions.

Any turnaround in the underlying economy and, by extension, corporate profits should lift equity markets higher. This will be helped further as countries around the world reduce interest rates towards a normal policy setting. The lowering of interest rates has already started in Europe with the US Federal Reserve (Fed) also expected to announce a cut in the federal funds rate at the September meeting.

In contrast, the raising of official interest rates began much later in Australia and official interest rates have not risen as high. As such, inflation is still sitting well above the Reserve Bank of Australia's target band of 2-3%.   Furthermore, the impact of the recent Stage 3 tax cuts have yet to be seen. The next RBA Board meeting is on 6 August and, although rates may stay on hold until after Christmas, any change in rates over the next couple of meetings are more likely to be up than down.

There is still a heightened level of risk around the world that may impact on the global economy and markets. The changing political landscape in Europe and potentially in the US is likely to impact with a risk that US inflation is further ignited.

Furthermore, the conflicts in Ukraine and Israel and tension in the South China Sea could have a major influence on markets if there were further escalation (e.g. if the conflict in Israel widens to neighbouring countries). Heightened risk generally sees a run of money to safe haven assets such as Gold, US Treasuries and the US Dollar.

The world's second largest economy (China) continues to struggle to mount a strong and sustainable post-COVID bounce. However, despite significant problems in the Chinese property market which accounts for around 30% of its market, growth in the Asia Pacific region is expected to be strong at 3.9% for 2025 (down from an expected 4.1% in the current year).

The weak Yen has been a boon for Japanese exporters, who comprise 20% of Japan's economy but 35% of the stock market weight. With the Bank of Japan signalling little urgency to raise interest rates, the weak Yen and tailwind for exporters and corporate profits are likely to persist.

Our views on the various asset classes are outlined below.

<u>Australian Equities</u>

Within Australian Equities, we recommend investors hold a neutral position in both large cap stocks and in smaller companies.

Australian equities have underperformed global equities over the last quarter due to the higher exposure to resource stocks and a lower exposure to technology stocks. However, the forward Price to Earnings ratio remains relatively high compared to other regions after taking into account the relatively lower expected Earnings Per Share growth of Australian stocks.

Risks still exist to the outlook for Australian equities and a delay in interest rate cuts may make equities particularly vulnerable as companies will be faced with higher funding costs and softening demand for their goods and services.

International Equities

With the outlook for equity markets improving, we recommend investors move to a neutral position in International developed and emerging markets.

Falling interest rates and rebounding economies will help support equity prices particularly in Europe and Emerging markets where stock prices look relatively cheap. The very strong recent performance of US large cap tech stocks has resulted in small to mid cap US stocks looking attractive from a valuation perspective.

Regarding currency, the expected fall in global interest rates and a stable rate in Australia is supportive of a stronger Australian Dollar, albeit that the aforementioned global conflicts may help to support the US Dollar. As such, consideration should be given to hedge global currency exposure.

Property

We recommend investors move to a neutral position to both Australian property and International property. Valuations look attractive especially given the expected fall in official interest rates around the world which is likely to provide further support.

We maintain a negative view on office space (which remains structurally challenged) and the retail sector. We maintain a positive outlook for industrial property and are neutral on the healthcare sector. Similar dynamics are at play in global property markets.

Fixed Interest

Bond yields are offering good value (especially in Australia) and offer protection should there be a shock to the system (e.g. a heightening of global conflict). Furthermore, valuations receive support in a climate of falling official interest rates.

However, there is a risk, especially in Australia, of interest rates remaining higher for longer. Any rise in rates potentially brings with it a risk of a capital loss in bond investments.

Yields on corporate bonds look reasonable, but carry increased risk in the event of an economic downturn and credit contraction. As such, we favour Australian corporate debt over global debt. Floating rate corporate debt still looks attractive but as rates fall, fixed rate debt will come to the fore.

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.

Alternatives

We have moved to a neutral to overweight setting to Infrastructure especially given the current global interest rate environment. Private Equity investments are expected to continue to be well supported.

Despite higher valuations, 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, acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.