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EVIDENTIA GROUP

Quarterly Market Update

September 2024

The highlights:

- The US Federal Reserve (Fed) delivered a bold 0.50% rate cut in September, signalling a pivotal shift in its policy. After a prolonged focus on curbing inflation, the central bank has adopted a more balanced stance, also supporting employment and economic growth.

- China's central bank unveiled its most aggressive stimulus measures since the pandemic, designed to boost economic growth and support an ailing property market.

- Global shares shrugged off some periods of heightened volatility to end September and the third quarter of 2024 at all-time highs, boosted by the prospects of rate cuts that are typically viewed as positive for shares. Australian and Chinese markets were particularly strong in September thanks to the announcement of a stimulus package in China.

- Fixed interest (bond) markets performed well over September and the quarter, as bond yields declined on rate cut expectations, and bond prices rose.

Key markets — trailing total returns (%)

As at 30 September 2024	1 mth	3 mths	6 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australian shares	3.0	7.8	6.7	21.8	8.4	8.4	8.9
Australian small-cap shares	5.1	6.5	1.8	18.8	-0.6	4.4	7.0
International shares (hedged)	1.8	4.7	8.0	28.5	7.5	10.8	-
International shares	0.1	2.6	3.1	22.6	9.6	11.6	12.0
Developed market shares (hedged)	1.4	4.5	7.5	29.1	8.4	11.6	10.4
Developed market shares	-0.4	2.4	2.7	23.2	10.6	12.4	12.7
Emerging market shares (hedged)	5.4	6.3	12.7	23.1	0.5	4.9	-
Emerging market shares	4.3	4.7	7.4	17.3	1.8	5.2	6.5
International small-cap shares	-0.5	5.2	-0.2	16.1	3.6	8.4	10.6
International property (hedged)	2.5	13.5	11.2	25.2	0.1	0.3	4.6
International infrastructure (hedged)	2.1	11.8	13.1	25.8	5.8	4	6.9
Australian fixed interest	0.3	3.0	2.2	7.1	-1.2	-0.4	2.4
International fixed interest (hedged)	1.1	4.0	3.8	9.1	-1.5	-0.4	2.3
Cash - bank bills	0.4	1.1	2.2	4.4	2.8	1.8	1.9

Market observations

The third quarter of 2024 delivered solid returns across all major asset classes, despite periods of market volatility. Recession fears sparked sell-offs in global share markets, with declines of 6% in early August and 4% in early September, followed by strong recovery rallies as concerns eased. Over the quarter, we also saw a broadening of returns in shares, with previously underperforming areas showing strength. Value sectors, small companies, infrastructure, property, and Chinese shares all posted strong gains.

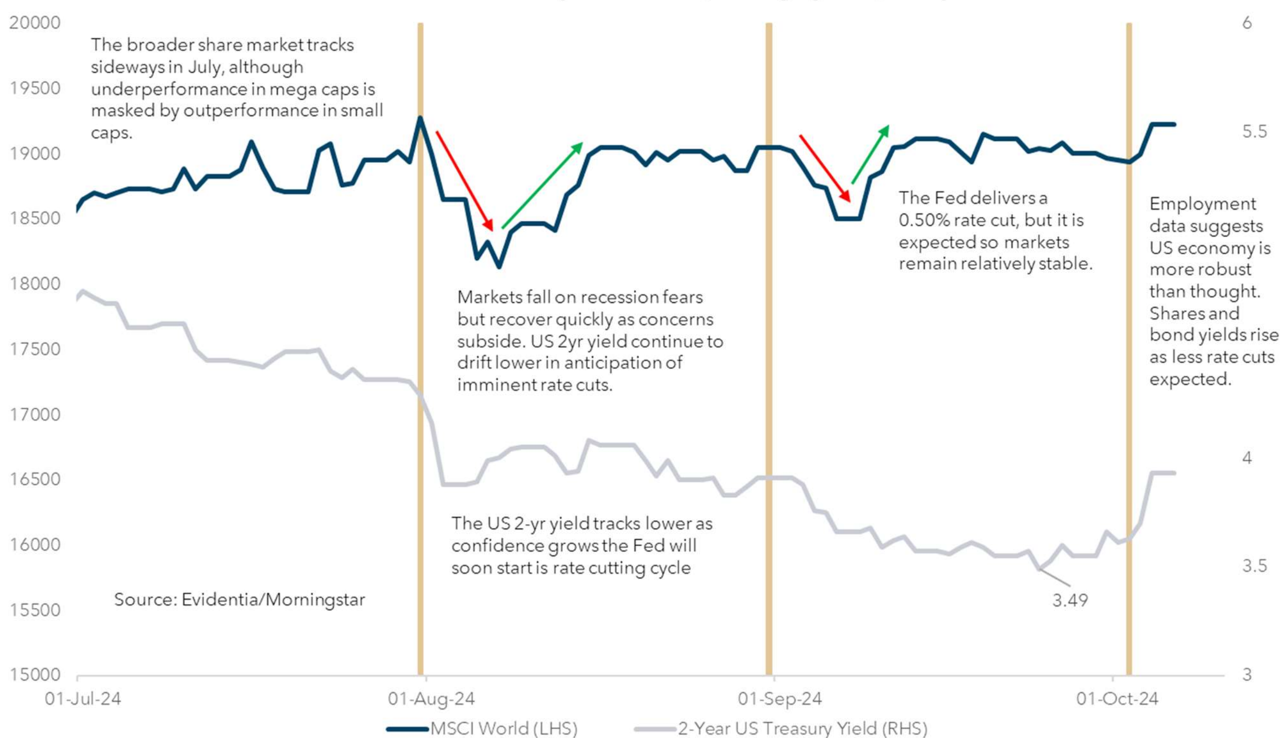
Australia's share market outperformed its global peers thanks to strong contributions from the banks and a late China-fuelled rally from the materials sector. A series of stimulus announcements to boost China's economic recovery, including rate cuts and property support measures, powered an impressive 36% trough-to-peak rally in Chinese shares during September. While previous stimulus rallies have been short-lived, there is an ongoing debate about whether this time will be different.

Fixed interest markets remained more cautious, with the bond yield curve reflecting expectations of faster interest rate cuts — historically a sign of an approaching recession. Bond yields fell materially over the quarter on softer growth prospects, driving bond prices higher.

The most anticipated macroeconomic event of the year arrived on 19 September when the Fed cut its cash rate by 0.50%. Although the move was large, it had little impact on markets as it was widely expected. Futures markets now predict the US cash rate will fall to 3.1% within the next 12 months (from 4.75-5.00%). The Reserve Bank of Australia (RBA) cash rate is expected to drop to 3.4% (from 4.35%).

Looking ahead, we see the start of the current rate-cutting cycle as a positive for risk assets. Asset classes such as infrastructure, property, small companies, and long-duration growth assets are well-positioned to benefit from falling rates and yields.

Despite elevated valuations, robust earnings growth and resilient, albeit modest, economic activity should continue to support global shares more broadly. However, risks remain, particularly if the economic slowdown accelerates due to rising unemployment or weakening consumer demand. In Australia, we remain cautious about earnings growth and economic conditions. With bonds having performed strongly on the back of falling yields, this may present an opportunity to reduce overweight positions and return to a more neutral stance.



Economic review

Australia

There was no respite for struggling Australian households from the Reserve Bank of Australia (RBA) as it maintained its cash rate at 4.35% for the seventh consecutive meeting in September. Although annual core inflation — the RBA's preferred measure which excludes volatile items — fell to 3.4% in August from 3.8% in July, the central bank reiterated it doesn't expect inflation to return sustainably to the mid-point of its 2-3% target range until 2026. Explaining the decision to keep rates on hold despite rate cuts abroad, Governor Michele Bullock noted that the RBA hadn't raised rates as aggressively as other central banks.

Australia's labour market remains tight, despite signs of gradual easing. Record participation rates, high job vacancies, and stabilising working hours kept the unemployment rate steady at 4.2% in August, matching forecasts. Since rate hikes began, Australia's unemployment rate has risen by just 0.6%, compared to 0.8% in the US and 1.6% in Canada. This suggests that while the RBA's restrictive monetary policy may be frustrating for households, it is balancing both employment and inflation objectives within its dual mandate.

US

September marked a long-awaited turning point for the Fed, as it delivered an aggressive 0.50% rate cut, bringing the target range down to 4.75% to 5.00%. This marked the first change since July 2023 and the first cut since the pandemic began in March 2020. The Fed's outlook also suggested another 0.50% in cuts by year-end, but this is more guidance than a firm commitment and will depend on upcoming economic data.

The size of the rate cut — the Fed will typically move in 0.25% increments — initially raised concerns that the central bank may have left its policy shift too late and was now playing catch up. However, Fed Chair Jerome Powell downplayed these worries, describing the move as a "recalibration" to stay ahead of any potential softening in the job market. Encouragingly, jobless claims continued to fall, and stronger-than-expected corporate profits reassured markets a soft landing — a scenario in which a central bank successfully slows down an overheating economy without triggering a recession — remains achievable.

Europe

A further decline in European inflation, which fell from 2.2% in August to an estimated 1.8% in September, offered hope for further rate cuts. In response, the European Central Bank (ECB) lowered its cash rate by 0.25% to 3.5%. Economic growth indicators remain soft, with the eurozone's gross domestic product increasing by only 0.2% in the second quarter of 2024.

After its first rate cut since the pandemic in August, the Bank of England (BoE) held rates steady at 5.0% during its September meeting. In contrast to the Fed and ECB, the BoE is expected to adopt a more cautious approach to easing, with gradual cuts anticipated to bring the base rate down to 3.5% by the end of 2025. Headline Inflation remained flat at 2.2% in August.

Asia

In its ongoing battle to kickstart China's economic recovery and support its ailing property market, the People's Bank of China (PBoC) announced a raft of stimulus measures. These covered many areas, including rate cuts (rates and the bank reserve requirements), further relaxation of housing regulations (mortgages and downpayments), using the central bank's funding to buy shares, and more support to buy unsold homes.

After surprising the market with a rate hike in July, the Bank of Japan (BoJ) maintained rates at 0.25% in September. Japan's economy is expanding on solid consumption and core inflation remains above the central bank's 2% target, keeping alive expectations for further rate hikes.

Asset class review

Australian shares

After a volatile opening to the month sparked by recession fears, the Australian share market rallied strongly in September and outperformed other major global markets. The S&P/ASX 200 Index climbed +3.0% in September, recording its fifth straight month of gains, and jumped an impressive +7.8% for the quarter. Smaller companies surged past their larger peers in September but lagged over the quarter — the S&P/ASX Small Ordinaries Index recorded gains of +5.1% and +6.5%, respectively.

Sector performance was mixed in September. Materials (+13.1%) posted impressive returns as China's stimulus measures triggered a late-month rally in commodity prices which flowed through to Australia's miners. Information technology (+7.4%) and real estate (+6.6%) also performed well. Defensive sectors, health care (-3.2%), and consumer staples (-1.7%) were the weakest performers over the month. Sector returns were broadly positive over the quarter. Information technology (+16.1%) bucked a weaker global trend to post an impressive quarter, thanks in part to the performance of market darling WiseTech. Real estate (+14.4%) was another standout sector, with the market betting the RBA will soon follow its global peers and start cutting rates. Energy (-6.2%) was the worst-performing sector, with a rapid decline in global oil demand, led by China, fuelling a sharp sell-off in oil markets.

What fund managers are saying….

"Markets are expecting the US Fed to cut rates several more times in the next six months (although present expectations may be a bit overly optimistic). It seems increasingly likely that the RBA will also soon begin cutting rates (as is partially priced but will likely become more fully priced in coming months).

A rate cut cycle is usually positive for equity markets, especially cyclical and small cap equities, and the relative performance of these sectors will be a good indication of the market's expectation regarding the likelihood of a soft economic landing.

We remain optimistic but cautious about the market outlook and, while we expect a modest consolidation of recent moves, at this stage the catalysts for a significant selloff are not present. Presently the probability of a soft landing seems reasonable in the US with the Fed having now embarked on a rate cut cycle at a point that seems relatively early in the slowdown phase.

The probability of a soft landing in Australia will be determined in large part by how swiftly the RBA begins cutting rates. We think there is a rising probability that the RBA could cut earlier than currently expected."

SGH Hiscock & Company

International shares

Despite periods of volatility, international share markets regained momentum to finish the September quarter in front. The currency-hedged MSCI All Country World Index gained +1.8% in September and +4.7% for the quarter. A strengthening Australian dollar provided a headwind for the unhedged equivalent index, which edged +0.1% and +2.6% higher over the same periods. Small companies trailed their larger peers over the month but led over the quarter. The MSCI World ex Australia Small Cap Net Return AUD Index retreated -0.5% in September but climbed +5.2% over the quarter.

Sector performance was broadly positive over the month. Utilities (+5.0%) — among the most sensitive sectors to rate changes due to a heavy reliance on debt financing — was a winner, as were the communication services (+4.0%) and consumer discretionary (+4.9%) sectors. Healthcare (-3.3%) and energy (-3.6%) were the only detractors. It was

a similar story over the quarter. Rate-sensitive utilities (+15.7%) and real estate (+15.3%) sectors stood out, as did financials (+8.5%), materials (7.6%) and industrials (+7.5%). Energy (-3.8%) was the only developed market sector to fall, dragged lower by weaker oil prices.

US shares recovered quickly after shaky starts in both August and September to end the quarter at record highs. The S&P 500 Index rose +2.1% in September and +5.9% over the quarter, while the tech-heavy Nasdaq Composite Index advanced +2.8% over both the month and quarter. European shares were boosted by an ECB rate cut, with the Euro Stoxx 50 Index ticking up +0.9% and +2.4%. After reaching new highs in early July, the Japanese market then corrected sharply over the rest of the quarter after the BoJ raised interest rates, and the yen subsequently strengthened against the US dollar. The Topix Total Return Index retreated -1.5% and -4.9%. Boosted by the MSCI China Net Total Return Index, which jumped +23.3% in September on the announcements of extensive stimulus measures, emerging markets delivered strong returns. The MSCI Emerging Markets Index (Hedged) moved +5.4% higher in September and +6.3% for the quarter.

International shares - trailing total returns (%) all local currency

As at 30 September 2024	1 mth	3 mths	6 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australia	3.0	7.8	6.7	21.8	8.4	8.4	8.9
US	2.1	5.9	10.4	36.4	11.9	16.0	13.4
Europe	0.9	2.4	0.2	22.7	10.0	9.4	7.1
UK	-1.5	1.8	5.6	12.4	9.1	6.0	6.2
Japan	-1.5	-4.9	-3.3	16.6	12.0	13.4	9.6
China	23.3	22.2	30.7	22.4	-5.2	0.8	3.5
Asia (ex-Japan)	7.4	8.0	16.5	26.8	2.6	7.4	6.4

What fund managers are saying….

“Markets appear to have sniffed out the coming shift in Fed policy, with a leadership rotation beginning to unfold in mid-July following the unexpectedly favourable June CPI release. This data paved the way for the Fed to embark on the cutting cycle, and over the past two and a half months market leadership has been very different from what was seen in 2023 and the first half of 2024. Specifically, investors are beginning to favour areas that will benefit from an economic reacceleration as well as lower rates, including value over growth, small over large, equal-weighted over cap-weighted indexes, and the broader market (the S&P 493) over the Magnificent Seven.

In fact, the Magnificent Seven have underperformed the S&P 493 (the rest of the index) by -11% since that release. Importantly, the S&P 500 Index has continued to advance, disproving the notion that stocks can’t move higher without the Magnificent Seven leading the way. While the overall index returns may remain more muted as rotations continue to play out beneath the surface, it’s important to note that U.S. equities have outperformed cash by a wide margin in the year following past cutting cycles that resulted in soft landings.

We believe the recent leadership rotation is a preview of what should continue to play out in the coming quarters, as an accelerating economy makes earnings growth less scarce and helps drive broader market participation. Three (recent) positive developments — upward revisions showing a healthier consumer (and corporate America), an aggressive Chinese policy pivot and the commencement of a rate-cutting cycle — should help the Fed stick the landing.”

ClearBridge Investments

Property and infrastructure

The start of the rate-cutting cycle in the US and declining bond yields provided a tailwind for rate-sensitive global property and infrastructure asset classes. Recording a third month of consecutive gains, the property-focused FTSE EPRA Nareit Developed Index (Hedged) climbed +2.5% in September, taking the quarterly returns to an impressive +13.5%. The FTSE Global Core Infrastructure 50/50 (Hedged) Index also performed well, recording +2.1% and +11.8% over the same period.

Fixed interest

Fixed interest markets were positive over September and the quarter, buoyed by the prospect of lower interest rates. Although movements were more muted in September, government bond yields declined significantly over the course of the quarter. The 10-year US Treasury yield fell 0.62% to 3.78%, while the 10-year Australian Government Bond yield retreated 0.34% to end the quarter at 3.97%. This resulted in strong returns for global and Australian bond indices. The Bloomberg Global Aggregate Bond Hedged Index gained +1.1% for the month and +4.0% for the quarter, while the local Bloomberg AusBond Composite 0+ Yr Index increased +0.3% and +3.0%.

Credit markets (corporate bonds) delivered robust returns as spreads (the additional yield a corporate bond offers over a government bond with the same maturity as compensation for the additional risk taken) tightened further. The Australian investment-grade credit benchmark, the Bloomberg AusBond Credit 0+ Yr Index, rose +0.5% in September and +3.1% over the quarter. Meanwhile, global credit, as measured by the Bloomberg Global Aggregate Credit Total Return Index Hedged AUD, gained +1.4% and +4.6%. High yield spreads also tightened, boosting returns for the Bloomberg Global High Yield Total Return Index Hedged AUD, which advanced +1.7% in September and an impressive +5.2% for the quarter.

Fixed interest - rates, yields and spreads

As at 30 September 2024	month end	1 mth earlier	3 mths earlier	6 mths earlier	12 mths earlier	10 yr average
Australian RBA cash rate	4.35	4.35	4.35	4.35	4.10	1.75
Australian 10-year government bond yield	3.97	3.97	4.31	3.96	4.49	2.52
Australian corporate composite bond spread	1.27	1.30	1.32	1.42	1.52	1.27
US Fed funds rate	5.00	5.50	5.50	5.50	5.50	1.83
US 10-year Treasury yield	3.78	3.90	4.40	4.20	4.57	2.41
US corporate bond spread	0.89	0.93	0.94	0.90	1.21	1.22
US high yield bond spread	2.95	3.05	3.09	2.99	3.94	4.22
Bloomberg AusBond Comp 0+ Yrs yield	4.11	4.12	4.53	4.12	4.53	2.45
Bloomberg Global Aggregate yield	3.33	3.48	3.90	3.74	4.22	2.01

What fund managers are saying….

"The Federal Reserve recently surprised the market with a 50-basis point rate cut, signalling what is expected to be a steady easing of monetary policy. In contrast, the Reserve Bank of Australia held rates in September but is expected to follow suit in the near future.

The market has been anticipating that central banks would start cutting rates by the end of this year or early 2025, in line with its global peers. However, we do not expect rates to return to the lows seen prior to the current rate-rising cycle. Investors will need to navigate a higher for longer landscape and manage their portfolios accordingly.

The key question for investors is how to secure reliable, consistent income while managing risk in this environment. Investment grade credit offers high quality income with minimal risk of default. Credit spreads are currently near their long-term averages. When combined with higher base rates, it creates an attractive proposition from an income perspective.

Investment-grade credit is particularly well-positioned for a higher for longer environment, as the underlying companies tend to maintain more manageable debt levels, exhibit greater flexibility in managing their cost base, and possess stronger pricing power for their products. These factors place them in a better position to navigate through the economic cycle."

Yarra Asset Management

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