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EVIDENTIA GROUP

Monthly Market Update

July 2024

The highlights:

- The US Federal Reserve (Fed) signalled its strongest intention yet to provide interest rate relief at its upcoming September meeting, contingent on continued moderation in economic conditions.
- Shares and fixed interest (bond) markets pushed higher in July as investors anticipated interest rate cuts, driven by signs of cooling growth and easing inflation pressures.
- International shares broadly extended recent gains, but investors rotated out of high-flying mega-cap technology companies and into rate-sensitive sectors as earnings results fell short of lofty expectations. Meanwhile, softer inflation data in Australia, which almost rules out the potential for another rate hike, sent Australian shares soaring to record highs.
- Falling bond yields provided a favourable environment for both global and Australian bond returns, with government bonds and corporate bonds (credit) performing in line with each other.

Key markets — trailing total returns (%)

As at 31 July 2024	1 mth	3 mths	6 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australian shares	4.2	6.2	7.3	13.5	7.4	7.5	8.0
Australian small-cap shares	3.5	2.0	5.4	9.3	-0.6	3.5	6.3
International shares (hedged)	1.2	7.4	12.9	17.2	5.9	10.1	-
International shares	3.9	7.5	13.8	20.8	10.0	12.3	12.7
Developed market shares (hedged)	1.3	7.7	12.6	18.3	6.9	11.1	10.3
Developed market shares	4.1	7.9	13.8	22.1	11.1	13.3	13.5
Emerging market shares (hedged)	0.5	5.2	15.1	8.6	-1.7	3.5	-
Emerging market shares	2.6	4.3	14.4	9.7	1.2	4.5	6.3
International small-cap shares	9.5	9.1	13.1	14.9	5.3	9.4	11.4
International property (hedged)	5.5	9.2	6.9	7.0	-3.6	-0.3	3.5
International infrastructure (hedged)	6.4	8.5	12.4	9.4	3.8	3.7	6.6
Australian fixed interest	1.5	2.7	1.5	4.7	-2.2	-0.5	2.3
International fixed interest (hedged)	1.9	3.5	1.7	4.7	-2.5	-0.5	2.2
Cash - bank bills	0.4	1.1	2.2	4.4	2.6	1.7	1.9

Market observations

July marked a significant shift in market trends that have defined the year thus far. The US mega-cap technology sector, which had been the dominant force driving market gains in the first half of the year, led the sell-off in July. Despite this, the fundamentals of these companies remain solid. We view this pullback as a technical correction — a necessary pause after valuations surged too high too quickly on the wave of AI-related optimism.

In addition to the tech sell-off, other notable sector reversals occurred in July. The heat map chart below highlights the reversal in returns in several key sectors that occurred in July compared to the 12 months prior. Smaller companies outperformed their larger counterparts, *value* outshone *growth*, and previously lagging sectors like infrastructure delivered notable outperformance.

In earlier August, the US jobs report for July confirmed an unexpected rise in the unemployment rate to 4.3%, up from 4.1% the previous month and 3.7% six months earlier. This spooked global markets, triggering a swift repricing on the back of renewed recession fears. Consequently, expectations for cash rates plummeted, with aggressive rate cuts priced in, not only by the Fed but also by other major central banks.

The US cash rate projection for 12 months out dropped from 4.3% to 3.4%, and in Australia, from 4.3% to 3.7%.

This shift has provided support for interest rate-sensitive sectors during the sell-off, such as infrastructure and property.

Over the past two years, we have observed significant swings in investor sentiment, oscillating between overly optimistic and overly pessimistic views on economic growth. The current shift towards a more pessimistic outlook seems to us to be somewhat of an overreaction. We believe that the medium-term outlook remains robust, although elevated valuations in certain areas may limit the potential for outsized gains.

Although July and early August brought about a notable shift in market dynamics, we maintain a cautiously optimistic view, recognising the market's inherent strengths even amidst short-term fluctuations.

	Financials	Energy	Materials	Industrials	Consumer Discretionary	Consumer Staples	Health Care	Communication Services	Information Technology	Utilities	Real Estate
12 months to 30 June 2024	32.33%	22.80%	17.18%	27.93%	22.43%	5.45%	15.00%	41.93%	47.30%	7.57%	9.74%
Month to 31 July 2024	5.30%	1.68%	3.09%	3.56%	0.36%	1.99%	2.70%	-3.51%	-2.33%	6.21%	6.39%

Source: Evidentia/Bloomberg. MSCI World Total Return Index sector returns.

Economic review

Australia

Investors breathed a collective sigh of relief as June's annual core Consumer Price Index (CPI) inflation surprised to the downside, coming in at 3.9%. Although the result was a tick above the Reserve Bank of Australia's (RBA) forecast of 3.8%, it was importantly below the 4% expected to trigger a rate hike. In response, the RBA left rates on hold at 4.35% at its early August meeting and updated its forecasts that inflation would return to its target band by Christmas.

Pressure in Australia's labour market continues to ease, though moderate job growth and near-record participation indicate ongoing resilience in the near term. The unemployment rate was 4.1% in June, up from 4% in May. Economic growth and consumer spending continue to soften as the elevated rate environment impacts demand. How households respond to easing budget pressures, as tax cuts flow through and inflation moderates, will be a key focus for the market in the second half of the year.

US

Rate relief is on the horizon in the US. Despite leaving rates on hold at 5.25%-5.50% at the Fed's July meeting, Chair Jerome Powell confirmed hopes that a rate cut "could be on the table as soon as the next meeting in September." Annual core Personal Consumption Expenditures (PCE) Price Index inflation — the Fed's preferred measure that excludes volatile items — was flat at 2.6% in June and in line with expectations. An unexpectedly weak US jobs report for July showed the unemployment rate reaching a post-pandemic peak and less job creation than forecast, stoking recession fears. This added further support for a rate cut in September.

Former President Donald Trump survived an assassination attempt in July. Meanwhile, President Joe Biden announced he would not seek re-election and endorsed Vice President Kamala Harris. The failed assassination attempt solidifying support for Trump and the prospect of a Harris presidency add layers of uncertainty to a contentious US election cycle.

Europe

Despite annual core inflation remaining flat at 2.9% in July, markets remain optimistic the European Central Bank (ECB) will cut rates again in September. Supporting the rate outlook, stubborn service inflation eased slightly in July as an expected boost from the Olympic Games in Paris failed to materialise. The ECB left rates unchanged at its mid-July meeting.

Struggling British households were given some respite in early August when the Bank of England (BoE) cut interest rates from a 16-year high of 5.25% to 5.00%. This is despite the bank expecting inflation to rise in the final quarter of the year — as the impact of earlier falls in energy prices fade — before returning to its 2% target early in 2026.

Asia

To prevent inflation from overheating and attempt to stabilise the recent weakness in the yen, the Bank of Japan (BoJ) raised rates to around 0.25% in July from the previous range of 0% to 0.1%. The BoJ also outlined a plan to unwind its government bond-buying program, which attracted investors to the yen, which climbed to its strongest level in more than four months. A sharp appreciation in the yen relative to the US dollar triggered an unwinding of the yen carry trade (borrowing cheaply in Japan to invest in higher rate markets overseas), causing significant market volatility and the BoJ to come out and assure investors it would not "raise rates when markets are unstable."

To support the recovery of China's problematic property market, the People's Bank of China (PBOC) unexpectedly lowered the one-year loan prime rate (LPR) — its key loan lending rate for corporates and households — from 3.45% to 3.35% in July. While positive for prospective homebuyers, the move is expected to apply further pressure to local banks already facing record-low interest rate margins.

Asset class review

Australian shares

Australian shares reached record highs in July as increasing confidence in interest rate relief in the US and promising local inflation data were favourable for returns. The S&P/ASX 200 Index outpaced most global markets and recorded its strongest monthly return of the year with an impressive gain of +4.2% in July. Smaller companies trailed their larger peers but recorded solid absolute returns as the S&P/ASX Small Ordinaries Index advanced +3.5%.

Sector performance was largely positive in July, although there was a wide return dispersion. A more positive interest rate outlook, which should provide some relief for households, provided a tailwind for consumer discretionary (+9.1%). Interest-rate-sensitive sector real estate (+6.7%) posted significant monthly gains. The major banks rallied, boosting the financials sector (+6.3%) as fears of another RBA cash rate rise subsided. A rate hike was anticipated to cause more harm to home loan arrears than it would benefit net interest margins (the difference between the interest rates a bank receives from loans and pays on deposits. Meanwhile, the highly concentrated utilities sector (-2.9%), dominated by a few key players, was the worst performer, giving up some recent gains as investors rotated into other areas of the market. Oil prices declined on weaker global demand, particularly from China, putting pressure on the energy sector (-0.4%), while lower commodity prices weighed on materials (-0.1%).

What fund managers are saying….

"This time last year, consumer confidence was at 1991 recession-type levels, retailers were downgrading every week, we had worn twelve interest rate hikes in a row and Macquarie Dictionary declared 'cozzie livs' (slang for cost of living) as its word of the year. Roll forward to today: consumer confidence has not budged, interest rates have increased another 25bp, retailers are downgrading again and the cost of living crisis has gotten so bad that the Liberal Party, historically the party that is pro-business and anti-government intervention, is arguing for divestiture powers over the supermarkets as a way to alleviate cost-of-living pressures. Against this backdrop, it might be surprising to note that three of the best-performing sectors for the ASX 200 this year (2023-24 financial year) were consumer discretionary (+23%), financial services (banks) (+29%) and real estate (+21%). While we were blindsided by the degree of re-rating in the banks, we were unsurprised that consumer discretionary and REITs performed so well against this tough backdrop. It all comes down to expectations."

Airlie Funds Management

International shares

International shares extended gains, boosted by falling government bond yields as easing inflationary pressure reassured investors a Fed rate cut was imminent. The MSCI All Country World Index advanced +3.9% in July, boosted by a weaker Australian dollar, while currency-hedged shares gained +1.2%. International small companies significantly outpaced their larger peers. The MSCI World ex Australia Small Cap Net Return AUD Index climbed an impressive +9.5%. Sector performance was solid over the month with few detractors. Interest-rate-sensitive real estate (+6.4%) and utilities (+6.2%) led the pack, while financials (+5.3%) also posted significant gains. Communication services (-3.5%) and information technology (-2.3%) underperformed as investors took profits in the mega-caps, underwhelmed by the latest round of earnings updates and sceptical about the sustainability of the outsized earnings from AI.

US shares rose more broadly in July, with the S&P 500 Index up +1.2%. However, a late-month rally was not enough to push the tech-heavy Nasdaq Composite Index into positive territory, it retreated -0.8%. The Euro Stoxx 50 Index edged down -0.3% in July, with weak household demand weighing on the consumer discretionary sector. The UK's FTSE 100 Index advanced +2.5% as a landslide Labour victory at the general election fuelled hopes for a sustained economic recovery. Volatility triggered by the BoJ's rate hike weighed on the performance of Japanese shares, with the Topix Total Return Index retreating -0.5%. Returns from emerging markets were positive — the MSCI Emerging Markets Index (Hedged) moved +0.5% higher — but unsurprisingly lagged developed markets, with weaker performances from index heavyweights China and Taiwan. Ongoing challenges in the Chinese property sector and moderating economic data weighed on the monthly performance of the MSCI China Net Total Return Index -1.4%.

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

As at 31 July 2024	1 mth	3 mths	6 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australia	4.2	6.2	7.3	13.5	7.4	7.5	8.0
US	1.2	10	14.8	22.1	9.6	15.0	13.2
Europe	-0.3	0.0	6.9	11.7	8.7	9.5	7.2
UK	2.5	3.6	12.0	13.0	10.1	5.8	6.2
Japan	-0.5	2.1	10.8	23.1	16.5	15.0	10.5
China	-1.4	-1.0	15.7	-12.1	-13.2	-4.2	0.7
Asia (ex-Japan)	0.1	5.7	17.9	9.3	-0.5	5.4	5.2

What fund managers are saying….

"The Fed's impending rate cuts should bolster the economy, in our view, and current financial stability is indicated by moderate delinquency, downgrade, and default levels. However, Q2 earnings commentaries have raised concerns, especially among lower-income consumers, which deserve attention. The labour market's condition is increasingly critical for the Fed's policy decisions, as employment and income growth are vital for consumer spending, a key economic driver. We're closely watching labour market data, with a focus on the August jobs report and initial jobless claims, though these may fluctuate due to seasonal factors. Geopolitical events, particularly in the Middle East, are also under scrutiny for their potential impact on markets and inflation. In Japan, recent equity market volatility seems driven more by currency strength affecting exporters than by a sharp change in economic conditions. The Bank of Japan's policy adjustments supporting the yen suggest that high-quality Japanese stocks may experience stable growth and possibly outperform, as inflation levels out, other countries' rate cut cycles progress, and the yen remains strong."

Goldman Sachs Asset Management

Property and infrastructure

The improving global interest rate outlook and declining bond yields provided tailwinds for the interest-rate-sensitive international infrastructure and property asset classes. The FTSE Global Core Infrastructure 50/50 (Hedged) Index jumped an impressive +6.4% in July, while the property-focused FTSE EPRA Nareit Developed Index (Hedged) gained +5.5%.

Fixed interest

July was a positive month for fixed interest markets. Government bond yields fell, and bond prices rose across all major markets, propelled by expectations of rate cuts. The 10-year US Treasury yield declined -0.37% to 4.03%, while in Australia, where the rate cut path is less clear, the 10-year Australian Government Bond yield was down a more modest -0.19% to end the month at 4.12%. In terms of returns, the Bloomberg Global Aggregate Bond Hedged Index advanced +1.9% in July, while the local Bloomberg AusBond Composite 0+ Yr Index gained +1.5%. Both indices are heavily influenced by the performance of government bonds.

Credit markets (corporate bonds) produced strong gains, in line with government bonds, as spreads (the extra compensation a corporate bond must pay above the so-called risk-free rate offered on a government bond with a similar maturity date) on investment-grade credit tightened. Australian credit benchmark Bloomberg AusBond Credit 0+ Yr Index rose +1.6% in July, while global credit — as measured by the Bloomberg Global Aggregate Credit Total Return Index Hedged AUD — posted an impressive gain of +2.1%. Returns from global high yield credit were also strong, supported by the prospect of lower interest rates, with the Bloomberg Global High Yield Total Return Index Hedged AUD advancing +1.7%.

Fixed interest - rates, yields and spreads

As at 31 July 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	1.72
Australian 10-year government bond yield	4.12	4.31	4.42	4.01	4.06	2.51
Australian corporate composite bond spread	1.26	1.32	1.38	1.45	1.66	1.26
US Fed funds rate	5.50	5.50	5.50	5.50	5.5	1.74
US 10-year Treasury yield	4.03	4.40	4.68	3.91	3.96	2.39
US corporate bond spread	0.93	0.94	0.87	0.96	1.12	1.23
US high yield bond spread	3.14	3.09	3.01	3.44	3.67	4.24
Bloomberg AusBond Comp 0+ Yrs yield	4.29	4.53	4.56	4.12	4.3	2.44
Bloomberg Global Aggregate yield	3.62	3.90	4.06	3.59	3.85	1.98

What fund managers are saying….

"In recent months, global credit markets have shown impressive resilience despite challenges like volatility with US Treasuries, surprising economic data and global political uncertainties. Looking ahead to the second half of the year, the upcoming US presidential election could add more uncertainty to the mix. However, developed market central banks have finally started cutting rates after much anticipation, a trend likely to continue amid the ongoing global economic slowdown and subdued inflation. While some investors remain cautious about potential spread widening and are prepared to pivot toward riskier assets in a market selloff, we believe it's time to 'shake the trees' in an effort to capitalise on compelling opportunities in today's market."

Franklin Templeton