Monthly Market Update

December 2024

The highlights:

- The US Federal Reserve (Fed) delivered another 0.25% interest rate cut in December but surprised markets by reducing the number of expected rate cuts in 2025.
- International shares closed out a stellar year with a more mixed month in December. A weaker Australian dollar boosted returns from unhedged exposure but was a drag for hedged exposure.
- Australian shares rounded off a strong year of double-digit gains with a softer finish, as global market volatility and weakness in the materials sector weighed on broader market returns.
- Global and local fixed interest markets faced challenges as rising bond yields and inflation concerns took their toll.

Key Markets — Trailing Total Returns (%)

Source: Evidentia/Bloomberg

As at 31 December 2024	1 mth	3 mths	6 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australian Shares	-3.2	-0.8	6.9	11.4	7.4	8.1	8.5
Australian Small Cap Shares	-3.1	-1.0	5.5	8.4	-1.6	4.0	7.3
Global Shares (Hedged)	-1.7	1.2	5.9	19.6	5.7	9.5	-
Global Shares (Unhedged)	2.7	10.9	13.9	29.5	11.2	12.9	12.3
Developed Markets Shares (Unhedged)	2.5	11.9	14.6	30.8	12.2	14.0	13.1
Emerging Markets Shares (Unhedged)	5.1	3.1	7.9	18.5	3.5	4.3	6.6
Global Small Cap Shares (Unhedged)	-1.0	9.6	15.3	19.6	6.3	9.2	10.5
Global Listed Property (Hedged)	-6.4	-7.5	5.0	2.8	-5.6	-1.4	2.6
Global Listed Infrastructure (Hedged)	-5.1	-3.4	8.0	12.1	2.1	2.9	5.9
Australian Fixed Interest	0.5	-0.3	2.7	2.9	-0.8	-0.2	2.0
Global Fixed Interest (Hedged)	-0.9	-1.2	2.7	2.2	-1.9	-0.5	1.8
Cash - Bank Bills	0.4	1.1	2.2	4.5	3.2	2.0	1.9

Market observations and outlook

Global shares ended 2024 on a high note, with the December quarter delivering strong gains fuelled by resilient economic growth, robust corporate earnings, and two US Federal Reserve (Fed) rate cuts. The US technology sector, a key driver of market performance over the past two years, led the rally.

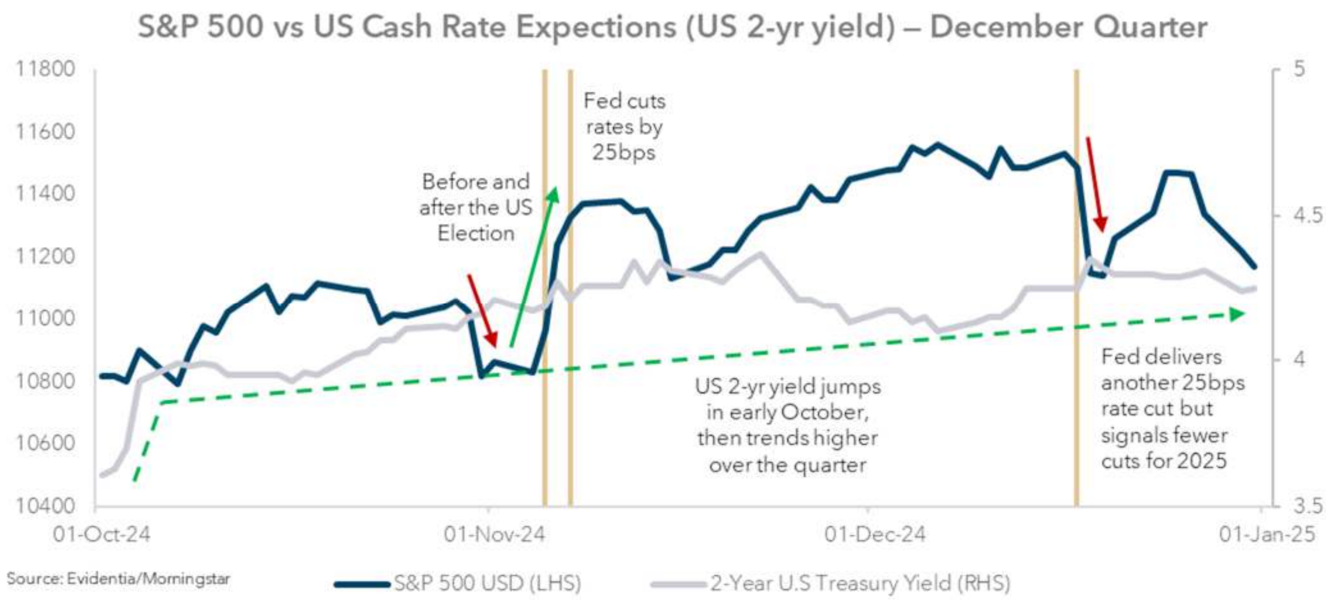
Market sentiment shifted significantly during the quarter. October was subdued as investors exercised caution ahead of the US election. November saw a sharp rally following Donald Trump's decisive victory and a Republican sweep of Congress, which boosted expectations for deregulation, tax cuts, and tariffs. However, momentum waned in December as the Fed lowered its rate cut projections, citing persistent inflation concerns. In Australia, stubborn inflation and weakening demand from China weighed on local shares. Still, 2024 was a stellar year for shares. The MSCI ACWI Index surged +29.5%, building on 2023's +21.5%, while the S&P/ASX 200 Index advanced +11.4%.

Fixed interest markets faced challenges as rising bond yields and inflation concerns took their toll. Long-term government bonds, particularly US Treasuries, experienced the steepest losses, while Australian short-term credit posted modest gains. Despite two rate cuts during the quarter, the Fed's December guidance surprised markets, projecting only two additional 0.25% cuts in 2025. Central banks have emphasised that reducing inflation further will remain difficult, with interest rates likely to stay significantly higher than pre-COVID levels.

As we enter 2025, several factors provide a supportive backdrop for markets. Continued, albeit slower, rate cuts, economic growth aligning with long-term trends, and stimulatory fiscal policies worldwide are boosting aggregate demand, creating a favourable environment for share valuations and earnings growth.

However, elevated valuations suggest that shares are priced for perfection, requiring sustained earnings growth to drive further gains. Any downward revision in growth expectations could prompt a market correction, reinforcing a cautious approach to overweighting shares. The "Magnificent 7" — the tech giants that accounted for nearly 60% of the S&P 500 Index's market cap gains in 2024 — remain pivotal. While market strength has broadened to include small caps, real assets, and financials, continued outperformance from these key players will be crucial.

Despite optimism for global growth, risks remain. These include the potential impact of Donald Trump's policies on global trade, inflation, and the US dollar as he returns to the White House later this month. The "last mile" of bringing inflation sustainably back to target levels may prove challenging, potentially delaying rate cuts. Additionally, China's ongoing economic struggles and the uncertain effectiveness of its stimulus measures pose risks to global growth, particularly for Australia and the local currency.



Economic review

Australia

Australia's economy ended 2024 much as it began, navigating the ‘narrow path’ to sustainable growth and employment. Inflation risks have eased, with the Reserve Bank of Australia (RBA) expressing cautious optimism that annual core consumer price index (CPI) inflation — 3.2% for November — is on track to meet its 2–3% target. The RBA continues to take a data-driven approach to determining how long restrictive interest rate settings should remain, particularly in light of global uncertainties.

The labour market continues to show resilience, with the unemployment rate dipping to 3.9% in November, supported by strong full-time job gains and reduced underemployment. Gross domestic product (GDP) rose 0.3% in the September quarter, driven largely by government spending. While it was the twelfth quarter in a row the Australian economy has grown, the pace of growth continues to slow under the strain of high interest rates and muted household spending. Annual growth of 0.8% — the slowest since the pandemic — highlights the challenges ahead for policymakers.

US

Balancing steady expansion with inflationary pressures, the US economy ended 2024 on a measured note. Consumer spending remained resilient, and the labour market continued to show strength, underscoring a robust economic foundation. However, the Fed’s commentary at its mid-December meeting reflected a more tempered outlook, as inflation’s grip proved stickier than anticipated.

The Fed delivered its second consecutive 0.25% rate cut but scaled back expectations for additional reductions in 2025, citing the core personal consumption expenditures (PCE) price index rising 2.8% year-over-year in November. While this recalibration briefly unsettled markets, the Fed’s measured approach underlines its commitment to achieving sustainable growth and steering inflation toward its 2% target.

Europe

The European Central Bank (ECB) delivered a holiday reprieve for households, trimming its key interest rate by 0.25% in December. While core inflation remained steady at 2.7% in November, the ECB acted on expectations that inflation would move back to its 2% target by the year-end. Despite the region's near-term economic weakness and significant geopolitical uncertainty, the ECB believes the outlook looks brighter, supported by rising real wages, a resilient labour market and easing financing conditions.

Asia

Inflation barely moved over 2024, with annual headline CPI rising just 0.2%, weighed by persistently weak domestic demand. A combination of employment concerns, a prolonged housing downturn, and the threat of tariffs from the incoming Trump administration has hit demand, even as the government ramps up stimulus. However, China closed 2024 with a renewed drive for economic recovery, as the People's Bank of China (PBoC) vowed to implement a "moderately loose" monetary policy in 2025 to boost domestic demand and stabilise growth.

Japan wrapped up 2024 with a mix of resilience and challenges, as core CPI inflation rose 2.7% and policy debates swirled at the Bank of Japan (BoJ), which kept rates steady at 0.25%. The yen faced pressure but staged a late rebound. A robust labour market and strong retail sales offered bright spots, even as industrial output softened, leaving markets eager to see how the BoJ navigates 2025.

Asset class review

Australian shares

Australian shares eased in December, trailing most global markets amid a backdrop of market volatility, rising bond yields, and subdued domestic economic indicators. The S&P/ASX 200 Index slipped -3.2% for the month, dragging quarterly returns of -0.8% into the negatives. Smaller companies performed similarly to their larger counterparts, with the S&P/ASX Small Ordinaries Index dropping -3.1% in December and -1.0% over the quarter.

Sector performance was mostly weak in December. Consumer staples (+0.6%) led the month, boosted by holiday spending. Information technology (+0.4%), industrials (+0.3%), and energy (+0.3%) also ended marginally higher in December. Materials (-4.5%) struggled with softer Chinese demand weighing on performance. After a stellar year, investors took profits on the banks, with financials (-4.1%) underperforming in the month. Despite the late-year pullback, sector returns were mostly positive over the December quarter. Financials (+5.9%) stood out, with falling wholesale funding costs, stable local interest rates, and a resilient house market all providing support. Communication services (+2.2%) and information technology (+1.6%) tracked their overseas peer group higher. Materials (-11.9%) and energy (-5.4%) were big losers over the quarter. The energy sector was impacted by the weak outlook for oil demand and relief that tensions eased between Israel and major oil producer Iran. China's economic woes and a slump in construction activity contributed to weaker commodity prices which weighed on the local miners.

What fund managers are saying….

"A market with ongoing volatility and a bit of a change in the macro regime to global interest rate cutting often triggers rotation amongst sectors. Leadership in the market can change, and I think banks are pretty ripe for that, given my view that the fundamentals are disconnected from valuations. You can see returns are in structural decline for the banks. Mortgage returns are in line with the cost of capital, yet competition is still increasing. Business banking gets you better returns, but that's also a new source of competition. And then if we do have interest rate cuts, that's another sort of headwind for bank earnings. And yet, they're trading on record high multiples, whether you look at absolute terms or relative to the market. And so, I don't think the risk-reward looks great for the banks. One way to demonstrate this is to compare CBA versus CSL — both stocks happen to be trading on about 26 times PE for FY25. For CBA, that's about 75% above its long-term average. For CSL, it's bang in line with their average, but the growth rates and returns are very different. For CBA the market's looking for about 2% growth over the next couple of years, at a 13% ROE. But CSL, the market's looking for 15% growth, high-teens growth, over the next couple of years and an 18% ROE. So, I think that shows you the big disconnect between the fundamentals and valuations in the banks.

But I think there are some potential catalysts down the track for the resources sector. I mean, China's policy pivot over the last few months is pretty meaningful. They've executed on the monetary policy side, the fiscal policy side that they still haven't fired those bullets yet, but I think they are in the barrel, they're ready to go. They're just waiting for Trump to come in and see how bad the tariffs are there. And I think the market's reaction to that in the resources sector is probably the initial reaction when tariffs are imposed, which is bad for resources. It's bad for global trade and growth and resources sell-off. But the secondary reaction could be that China will stimulate to offset these tariffs, which is good for commodities. So I think with that, and I think it's a structural change in China's policy stance, the risk-reward looks much better to me in resources than it does in the banks."

Fidelity International

International shares

International shares ended an impressive year with a mixed December. Ongoing weakness in the Australian dollar — due to a struggling Chinese economy, threats of US trade tariffs, and a sluggish economy — boosted unhedged exposure over the month and quarter. The MSCI All Country World Index climbed +2.7% in December and +10.9% for the quarter. In contrast, returns from the equivalent hedged index were significantly softer, with a -1.7% monthly decline and a +1.2% quarterly gain. Global small companies, as represented by the MSCI World ex Australia Small Cap Net Return AUD Index, slipped -1.0% in December but delivered a strong +9.6% for the quarter.

December sector highlights included consumer discretionary (+3.1%), which rallied on robust holiday spending, while interest in AI and the Magnificent 7 reignited to lift communication services (+2.6%) and information technology (+1.0%) higher. Elsewhere, sector performance was weak, with real estate (-7.3%), energy (-6.9%) and materials (-6.8%) leading the falls. Quarterly performance was also mixed, with consumer discretionary (+11.0%), communication services (+7.8%) and financials (+7.1%) outperforming, and materials (-10.6%), health care (-9.4%), and real estate (-7.6%) underperforming.

Regionally, Asian markets moved higher in December, while the US market cooled, reversing November's trends. The S&P 500 Index slipped -2.4% for the month but rose +2.4% over the quarter, while the tech-heavy Nasdaq Composite Index gained +0.6% and +6.3%, respectively. The Euro Stoxx 50 Index saw modest monthly gains of +1.9% but fell -1.8% over the quarter amid concerns about economic growth and the possible implications of Trump’s trade tariffs. Japan outperformed, with the Topix Total Return Index up +4.0% in December and +5.4% for the quarter, as a weaker yen boosted the earnings outlook for many of its large exporting companies. Emerging markets outperformed developed markets in December thanks to a strong contribution from China but trailed over the quarter. The MSCI Emerging Markets Index gained +5.1% in December and +3.1% for the quarter.

International Shares - Trailing Total Returns (%)

Source: Evidentia/Bloomberg

As at 31 December 2024	1 mth	3 mths	6 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australia	-3.2	-0.8	6.9	11.4	7.4	8.1	8.5
US	-2.4	2.4	8.4	25.0	8.9	14.5	13.1
Europe	1.9	-1.8	0.5	11.0	7.1	8.0	7.1
UK	-1.3	-0.2	1.6	9.7	7.4	5.4	6.2
Japan	4.0	5.4	0.3	20.5	14.6	12.8	9.5
China	2.7	-7.0	13.7	19.5	-5.4	-3.2	2.0
Asia (ex-Japan)	1.3	-4.5	3.1	16.2	1.5	4.4	5.7

What fund managers are saying….

“Valuations alone are not a compelling reason to invest in a particular market or asset class, but they do provide a useful starting point when determining the potential for long-term returns. International small-caps usually trade at a premium to large-caps, but in 2024 this premium disappeared following several years of COVID-related disruption and supply chain challenges. In our view, international small-caps offer the potential to deliver stronger earnings per share (EPS) growth than their international large-cap peers in the period ahead as the economic environment improves. History shows that following periods of earnings decline, earnings growth for small-caps has typically exceeded large-caps. We expect this to occur again on this occasion, but this time coming from a point of extreme valuation support for small-caps that should help compound investor returns.”

T. Rowe Price

Property and infrastructure

Property and infrastructure assets struggled in December and over the quarter, weighed down by rising bond yields and growth concerns. The FTSE Global Core Infrastructure 50/50 (Hedged) Index fell -5.1% for the month and -3.4% for the quarter, while the property-focused FTSE EPRA Nareit Developed Index (Hedged) dropped -6.4% and -7.5%, respectively.

Fixed interest

Fixed interest markets closed the year cautiously, with expectations of a slower pace of rate cuts over the year triggering a sell-off in major government bond markets, driving bond yields higher. The 10-year US Treasury yield climbed sharply, gaining +0.40% in December and +0.79% for the quarter to end the year at 4.57%, while the 10-year Australian Government Bond yield rose more modestly, edging up +0.02% and +0.39% to finish at 4.36%. Rising yields were a headwind for returns, particularly for global bonds dominated by the US market. The Bloomberg Global Aggregate Bond Hedged Index moved -0.9% lower in December and -1.2% for the quarter. The local Bloomberg AusBond Composite 0+ Yr Index was more resilient, ticking up +0.5% for the month before easing -0.3% over the quarter.

Credit spreads (the additional yield a corporate bond offers over a government bond with the same maturity) were relatively stable over the month and tightened marginally over the quarter. Australian credit outperformed global credit, as the Bloomberg AusBond Credit 0+ Yr Index climbed +0.7% over the month and quarter. Global investment-grade credit, as tracked by the Bloomberg Global Aggregate Credit Total Return Index Hedged AUD, slipped -1.3% for the month and -1.8% for the quarter, with rising bond yields weighing on performance. With higher total yields, global high-yield credit fared better, retreating -0.3% in December but rising +0.9% over the quarter.

Fixed Interest — Rates, Yields & Spreads

Source: Evidentia/Bloomberg

As at 31 December 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	4.35	1.80
Australian 10-year government bond yield	4.36	4.34	3.97	4.31	3.96	2.56
Australian corporate composite bond spread	1.11	1.17	1.27	1.32	1.44	1.27
Bloomberg AusBond Comp 0+ Yrs yield	4.37	4.43	4.11	4.53	4.11	2.49
US Fed funds rate	4.50	4.75	5.00	5.50	5.50	1.94
US 10-year Treasury yield	4.57	4.17	3.78	4.40	3.88	2.47
US corporate bond spread	0.80	0.78	0.89	0.94	0.99	1.21
US high yield bond spread	2.87	2.66	2.95	3.09	3.23	4.18
Bloomberg Global Aggregate yield	3.68	3.52	3.33	3.90	3.51	2.06

What fund managers are saying….

"Following the Fed's December policy meeting, the US Treasury yield curve is no longer inverted, meaning there is not an explicit carry advantage to staying in cash. Conversely, there is a meaningful yield advantage to diversified fixed income. Furthermore, we expect the yield curve to steepen as policy rates are further reduced over the upcoming year, which would increase the carry advantage for diversified fixed income.

Expectations of Fed policy have evolved significantly. Three months ago, the market-implied policy rate at the end of 2025 was approximately 3%. Now, the market-implied policy rate is expected to be approximately 4%. The Fed projects two rate cuts in 2025, which is now slightly more than market expectations. Additionally, Fed expectations have further diverged from market pricing when we look out into 2026. Lastly, estimates of US Treasury term premium have risen and are elevated relative to the last five years. These considerations suggest there is some value in current pricing.

In conclusion, history suggests that income investors would be well served by rotating out of cash and into a diversified fixed-income basket if they have not already. Income-oriented investors are now receiving meaningfully higher yields relative to cash rates. Event studies around Fed rate-cutting cycles and reinvestment risk support this rotation."

Franklin Templeton