Quarterly Market Update

“A fool in the shower”

The challenge central banks face in getting interest rates right

September 2024

Contents

Executive summary

Coming into the September quarter, we were on guard for heightened levels of volatility, with a constellation of risks, juxtaposed against buoyant investment markets.

Whilst no individual risk was sufficient for us to turn more bearish in our portfolio positioning, the intransigence of the issues at hand, when contrasted against asset valuations, which were increasingly being referred to as 'priced to perfection', suggested that a disruption or significant challenge to the status quo, could threaten to throw markets into turmoil.

We were not wrong in these concerns, as the early days of August witnessed a rapid sell-off as the shine began to come off the Artificial Intelligence (AI) theme. That AI will prove to be an important technology is undoubtable. Whether it will prove to be a good investment for early adopters and early providers, is yet to be seen. Whilst it might seem harmless for members of senior management of companies like Meta, Alphabet and Microsoft to call for 'patience', time is a crucial component in investing. If you earn the same return over a longer time, your rate of return is mathematically lower.

Such a change in perspective, swung investors from 'glass half full' through to 'glass half empty' mode. Leading investors to reduce their holdings in US equities, and particularly, in technology companies. Adding fuel to this fire, was the reversal of the Yen 'carry trade' which had created a structural vulnerability to the specific combination of softening global shares, with strengthening Yen. In unwinding their positions, traders exacerbated the situation and drove the volatility further.

Fortunately, markets proved to be structurally robust, and the storm passed almost as rapidly as it had arrived, with approximately one week of drawdown, regained in just eleven trading days.

As we moved through September, much of the dust had settled, and investors, once again became focussed on central bank action – notably, that of the US Federal Reserve (Fed). Having seemingly waited for an interest rate cut, since the first interest rate rise in the back end of 2021, anticipation became not of 'if' but of 'how large'. Whilst most economists expected a 0.25% cut, the market increasingly priced in 0.50%, and so it was.

That the cut was larger than expected could have threatened to derail market sentiment, given it might suggest that economic health was weaker than the consensus might believe. However, the Fed has become quite adept at managing 'communication policy', and the market saw the move through rose tinted glasses.

As such, we were provided with a pleasant mix of falling yields, which inflated the value of bond holdings, whilst the reduction in interest rate expense and the justification for higher equity multiples, pushed share markets even higher.

A satisfying end to a period, in which we had prepared for the potential of a more challenging outcome.

In this report, we include a final 'special article' on the US presidential election, before digging into key areas of focus for the coming months. Our usual Asset Class Snapshot gives you a brief overview of the main investment markets we monitor, before we dive deeper into the economic landscape in our Global Economic review. Finally, we focus on each of our asset classes, in more detail.

Asset class snapshot

In the September quarter, asset prices rebounded after an early August correction, buoyed by falling bond yields and a series of interest rate cuts from central banks around the world. The US Federal Reserve kicked off a new easing cycle with a **50-basis point rate cut** in September, while the European Central Bank and others followed suit, responding to moderating inflation and weaker economic data. This shift in policy provided a lift to markets, despite lingering volatility and concerns about slowing global economic growth.

There was a noticeable **shift in market leadership** during the quarter, as **small cap** stocks, **value** stocks, and **real estate** staged a **comeback**. Meanwhile, **China's surprise stimulus efforts** - focused on boosting its sluggish economy - added another layer of support for markets. As central bank policies evolve, the focus is increasingly shifting towards balancing the need to ease inflationary pressures with the **growing imperative of maintaining a healthy labour market** and supporting economic growth.

Australian equities

Australian equities delivered impressive gains in the September quarter, with the ASX 300 rising by 7.8%[1], its best quarterly performance of 2024. This strong result came despite the **RBA holding firm** against the global trend of monetary easing, as domestic inflationary pressures prevented it from joining the rate cutting cycle. Lower bond yields, both domestically and internationally, provided a tailwind for Australian equities, further supported by a **reporting season** that was pleasantly **in-line** with expectations.

Whilst **large caps** generally outperformed **small caps** over the quarter, September saw a shift. **Small caps** rallied by 5.1%[2] for the month, surpassing the 2.8%[3] gain for **large caps**. This coincided with a resurgence in **value** stocks, which outpaced **growth** stocks as investors favoured more cyclical sectors. Sector performance was broadly positive, led by **information technology** and **real estate** over the three-month period. **Materials** staged a strong comeback, particularly in September, as **China's stimulus** measures benefited Australian miners. However, **energy** lagged due to weaker global oil demand.

International equities

International equities continued their positive trajectory in the September quarter, with the MSCI All Country World Index (ACWI) gaining a healthy 2.6% in Australian dollar terms. This brings the 12 month return for the ACWI to an impressive 22.6%, a **remarkable feat** considering the backdrop of high interest rates and pressured consumers globally.

A key development during the quarter was a noticeable rotation in market leadership. Whilst **Nvidia** - at the forefront of the artificial intelligence thematic - experienced a slight pullback after its stellar run, investors appeared to shift their focus towards more income-generating and cyclical sectors. **Utilities** and **real estate** emerged as strong performers, gaining 12.2%[4] and 12.4%[5] respectively, outpacing even **financials** and **industrials**, which delivered solid but more moderate returns.

This rotation was further evidenced by the outperformance of global **small cap** stocks, which gained 4.7%[6] for the quarter, exceeding the broader market by 2.1%. After lagging behind their **large cap** counterparts in recent years, particularly during the "Magnificent 7" era, smaller companies are now attracting renewed attention from investors. Their relatively attractive valuations and potential to benefit from lower interest rates should position them well for future growth. The shift in market dynamics also played out in the style arena, with **value** stocks gaining 5.5%[7] while **growth** stocks slipped back 0.4%[8]. This marks a potential turning point after several years of **growth** dominance.

However, it wasn't a winning quarter for all. **Energy** lagged, losing 5.8%[9] as oil prices weakened despite geopolitical tensions in the Middle East, and **information technology** experienced its first negative quarter in 12 months, giving up 2.7%[10]. These contrasting performances highlight the ongoing rebalancing occurring within global equity markets as monetary policy shifts to easing and investors reassess their priorities.

1 As measured by the S&P/ASX 300 - Total Return index
2 As measured by the S&P/ASX Small Ordinaries - Total Return index
3 As measured by the S&P/ASX 100 - Total Return index
4 As measured by the MSCI AC World - Utilities index (AUD unhedged)
5 As measured by the MSCI AC World - Real Estate index (AUD unhedged)
6 As measured by the MSCI All Country World Small Cap index (AUD unhedged)
7 As measured by the MSCI World Index Value index (AUD unhedged)
8 As measured by the MSCI World Index Growth index (AUD unhedged)
9 As measured by the MSCI AC World Energy index (AUD unhedged)
10 As measured by the MSCI AC World Information Technology index (AUD unhedged)

Real estate

Real Estate Investment Trusts (REITs) emerged as the top-performing asset class in Q3 2024, fuelled by a global decline in long-term bond yields. This decline was triggered by a **building global trend of monetary easing**, with the US Federal Reserve joining the charge by cutting rates by 50-basis points. Lower bond yields provided a significant boost to REITs by bolstering cap rates, a key valuation metric for the sector. After years of facing headwinds from rising rates, cap rates are now acting as a tailwind, driving strong performance.

Australian REITs (A-REITs) delivered a robust 14.3%[11] return for the quarter, bringing their 12-month return to a remarkable 45.9%. Global REITs (G-REITs) also performed admirably, returning 11.7%[12] for the quarter and 19.9% over the past year.

Several factors contributed to this strong performance. The **office sector**, previously under pressure due to increased remote work trends, enjoyed a more optimistic outlook. Additionally, the **retail sector**, a significant component of the REIT index, performed well on the back of better-than-expected consumer spending.

Alternatives

Growth alternatives delivered a mixed performance in Q3 2024. Infrastructure assets continued to provide stable cash flows and inflation-hedging benefits, with a focus on volume-linked assets and co-investment deal flow. Private Equity performance was steady, with a focus on operational improvement and attractive valuations. Real estate markets remained turbulent, but potential opportunities are emerging as some investors seek liquidity.

Income alternatives, particularly private credit, continued to benefit from strong market dynamics, with demand exceeding supply. Credit spreads remained compressed despite a slight increase in default rates. Asset-backed finance continued its growth trajectory as banks retreated from the sector. We remain cautious in deploying capital, focusing on specific opportunities in structured credit, asset-backed finance, and mid-market lending where attractive risk-adjusted returns are available.

Fixed income

Fixed income enjoyed a strong September quarter, buoyed by falling inflation and a series of rate cuts from major central banks. This supportive environment propelled both government bonds and credit higher, as markets rallied on expectations of further monetary easing. The US Federal Reserve's rate cut marked the official start of its easing cycle, and the move caused the US yield curve to un-invert for the first time in over two years, signalling a shift towards a **less restrictive monetary policy** stance. In contrast, the Reserve Bank of Australia (RBA) maintained its cash rate target, resisting the global easing trend as it continued to tackle **domestic price pressures**. Despite this, Australian bond yields also declined.

Global bonds delivered a strong 4.0%[13] return for the quarter, with longer-duration bonds outperforming their shorter-duration counterparts. Domestically, Australian bonds returned 3.0%[14], benefiting from falling yields and positive sentiment.

Credit markets also performed well, with corporate bonds outpacing government bonds as **credit spreads** narrowed. Australian credit returned 3.1%[15], while US investment-grade credit posted a 4.9%[16] gain. In the short-duration space, Cash returned 1.08%[17], in line with the RBA monetary policy setting.

[11] As measured by the S&P/ASX 300 A-REIT - Total Return Index
[12] As measured by the FTSE EPRA Nareit Developed - Net Return Index (AUD unhedged)
[13] As measured by Bloomberg Global Aggregate Bond Index (Hedged in AUD)
[14] As measure by Bloomberg AusBond Composite 0 +Yr Index
[15] As measured by Bloomberg AusBond Credit (0+Y)
[16] As measured by Bloomberg US Aggregate (AUD Hedged)
[17] As measure by Bloomberg AusBond Bank Bill

Australian cash rate

The Reserve Bank of Australia (RBA) maintained its stance in the September quarter, keeping **the cash rate unchanged** at 4.35% despite a building trend of monetary easing. This decision reflects the RBA's ongoing commitment to curbing inflation, which remains above the midpoint of their 2–3% target range.

While headline inflation fell to 2.7%[18] year-on-year in August, marking its first return within the target band since August 2021, the RBA remains cautious. The central bank emphasised that **this decline was largely influenced by government energy subsidies** and that underlying inflationary pressures persist.

The RBA acknowledged the recent weakening in economic growth but highlighted the resilience of consumer demand and the continued tightness of the labour market. It also emphasised the uncertainties surrounding the economic outlook, including the lagged effects of past rate hikes, geopolitical developments, and a softer outlook for China's economy. Despite the RBA's current hold on rates, market expectations are shifting towards a potential rate cut in early 2025. The central bank itself has indicated that it is not ruling out any future policy moves and will do what is necessary to return inflation to target sustainably.

Australian dollar

The Australian dollar **continued its march higher** against most currencies as the RBA remained on hold and most other developed market major central banks cut rates, narrowing the interest rate differential. This repricing of rate expectations supported the AUD against the US dollar (USD), resulting in a 3.9% rise to AUD 0.69[19] over the quarter and a 7.5% increase over the last twelve months.

[18] Australian Bureau of Statistics (ABS)
[19] FactSet. Data as of 30th September 2024.

US Presidential election

What a difference a few months can make

In our last Quarterly Market Update, we discussed the potential for a Trump vs. Biden rematch, considering how the campaign might unfold if both candidates made it to election day. However, given the age of both candidates, we noted that nothing was certain. Since then, the political landscape has shifted dramatically.

Just a few months ago, the political optics and polling suggested that Donald Trump was set to comfortably win the race. His campaign received an unexpected boost after a failed assassination attempt, which served to bolster his standing. The iconic image of Trump holding his fist defiantly in the air, with the US flag waving behind him and blood trickling down his ear, captivated audiences and played to his 'strong man' image. Polls reflected his rising popularity, while Biden steadily lost ground, reinforcing the perception that Trump's return to the White House was inevitable. But as we've seen, politics can change rapidly.

A new campaign dynamic

Fast-forward to today, and the race looks vastly different. Joe Biden, who had faced increasing scrutiny over his age and fitness for office, stumbled badly during a key debate. The event crystallised fears that Biden may not have the energy for another term, and shortly thereafter, he pulled out of the race. This decision left the Democrats scrambling for an alternative, and the new ticket - Vice President Kamala Harris and Governor of Minnesota Tim Walz - has injected fresh energy into the race.

Kamala Harris has proven herself to be a formidable opponent for Trump, especially during the second debate, where her sharp retort to Trump's offhand comments about immigrants "eating the dogs...they're eating the cats", caused a major stir. While the Trump camp may have anticipated a smoother ride, Harris' performance highlighted the growing challenge Trump faces. The Vice-Presidential debate between Walz and JD Vance was much more subdued, with no major shifts in momentum. Unsurprisingly, betting markets showed no significant changes post-debate, continuing the trend that VP debates rarely sway overall election outcomes, with voters typically focused on the presidential candidate.

The most polarising election in US history

As it stands, this election remains one of the most polarising in US history. The ideological gulf between candidates is striking, with both campaigns pulling in opposite directions - progressives versus conservatives. And yet, despite all the drama, the race is too close to call.

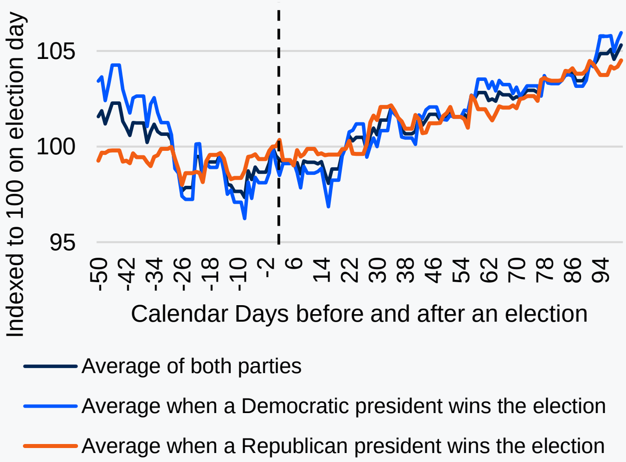
Polls have swung slightly in Harris' favour, but within the margin of error. It's worth noting that Trump's base has historically been underrepresented in polling, with many of his supporters opting not to participate. Similarly, betting markets favour Harris, but just like the polls, the gap is razor thin. Prominent pollsters like Nate Silver's FiveThirtyEight caution against reading too much into any single metric, noting that it's likely to come down to a few thousand votes in key battleground states. This uncertainty keeps markets on edge, as investors attempt to interpret the latest developments.

What markets have learned about elections

Political uncertainty creates headwinds for markets, and US elections are no exception. Historically, markets have tended to pull back in the months leading up to election day as anxiety grows around the potential outcomes. Yet once the election passes, markets usually bounce back, regardless of the result. This phenomenon can be attributed to one key factor: clarity. Markets dislike uncertainty, and elections are a major source of it. Once that uncertainty is removed, markets refocus on fundamentals like corporate earnings, interest rates, and overall economic conditions.

Interestingly, markets have historically performed well regardless of which party controls the White House, with the most favourable outcomes occurring under a split government where neither party holds both chambers of Congress. This balance seems to ease market fears of extreme policy changes. While US shares have delivered stronger average returns of 14.4% per year under Democratic presidents, since 1927, compared to 10% under Republicans, the best market performance has been when a Democrat is in office but Republicans control either the House or Senate. Conversely, the worst returns have occurred during a Republican sweep of both the presidency and Congress.

Figure 1: Markets tend to move higher following the US Presidential election, regardless of which party is in office

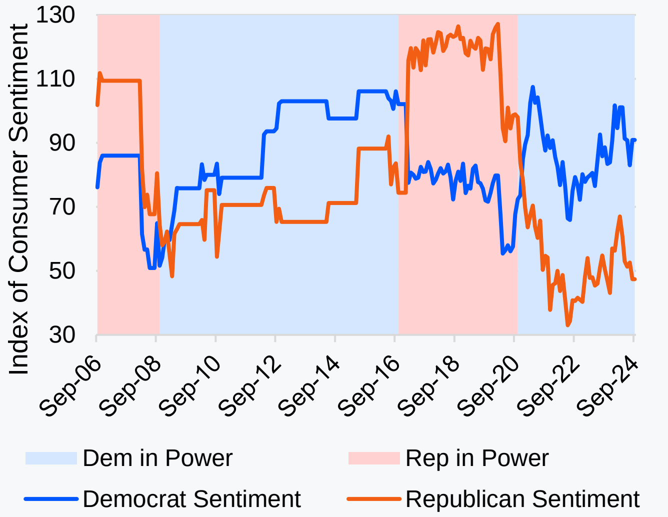


Source: S&P500 Total Returns (USD), Data from 1988 - 2021

Since 1980, US markets have generally moved higher after election day, with only two notable exceptions - 2000 and 2008. In both cases, market events (the tech bubble and the Global Financial Crisis, respectively) weighed more heavily on market performance than the election outcome itself.

For investors, the message is clear: letting political preferences dictate your investment strategy can be a costly mistake. A Pew Research Centre survey on American views of the economy revealed that partisanship often colours economic perceptions. Republicans tend to view the economy more favourably when one of their own is in the White House, while Democrats do the same when their party holds power. Yet, over time, markets have performed well under both parties.

Figure 2: Consumer Sentiment by Political Affiliation



Source: FactSet, as of 12/07/2024. University of Michigan Survey of Consumers, Consumer Sentiment Index by Political Party.

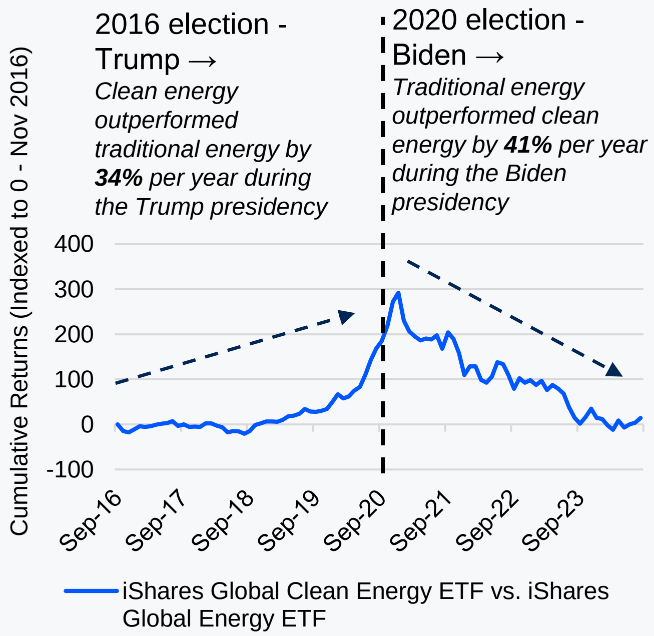
The stakes for investors

As election day draws closer, volatility may increase, but this is not necessarily a signal to make drastic changes to your portfolio. Historically, the equity markets have weathered election cycles without a significant long-term impact.

While each candidate's policy agenda around areas like taxes, tariffs, and energy will receive much attention in the coming weeks, it's important to remember that presidential policy leanings don't tend to sway markets as much as underlying fundamentals. Inflation, interest rates, and corporate earnings remain the primary drivers of market performance, not the occupant of the White House.

After the 2016 election of President Trump, investors may have been inclined to overweight the traditional energy sector. Similarly, after the 2020 election of President Biden, many favoured clean energy stocks. These moves would have produced poor returns.

Figure 3: Clean energy vs traditional energy



Source: FactSet. All returns are in USD and net of fees

There is also little reason to believe that either candidate will make meaningful strides toward fiscal austerity. Traditionally, conservative politics have been associated with limited government spending and fiscal prudence, but Trump's policies have often leaned in the opposite direction, favouring tax cuts and deregulation over deficit reduction. On the other side, Harris and Walz are likely to continue Biden's approach of using government spending to boost the economy, particularly in sectors like renewable energy and healthcare.

Looking ahead

As the 1988 Republican Presidential candidate Ross Perot once famously said, *"War has rules, mud wrestling has rules... Politics has no rules."* In this election, that sentiment rings truer than ever. With less than 30 days to go before the election, the chaotic nature of politics is making its mark, and investors should brace themselves for heightened market volatility. But they should also keep in mind that the larger forces driving the US economy remain intact. Amidst the unpredictability, one thing is certain: markets will move forward. Whether it's Trump or Harris who emerges victorious, maintaining a steady hand and avoiding the temptation to make reactionary moves is often the best strategy.

Global economic overview

Climbing a 'wall of worry'

As we closed out the financial year, asset prices had showed an impressive degree of resilience, resisting concerns of sticky inflation, heightened interest rates and consumers pressured by cost of living; broadly rallying. Indeed, in the closing remarks of our Quarterly Market Update at the time, we stated "there are clearly things to be concerned about, but there are also many things to be hopeful for, with probabilities balanced and outcomes wide".

However, by the end of July there was a growing belief amongst investors that assets might have become 'priced to perfection'; meaning that all good news had already been reflected in asset prices, leaving very little tolerance for surprises.

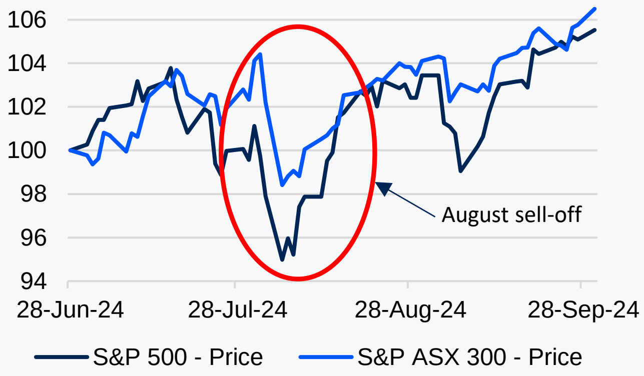
As we pressed into August, the precarious nature of market sentiment came firmly to the fore. Whilst locally our corporate earnings season progressed in a rather unremarkable way, the same cannot be said for US markets. Here, it is fair to say, cracks had started to appear in the Artificial Intelligence (AI) thematic that had driven markets for 18 months. Reflecting back to the beginning of 2023, a time when a majority of economists were expecting an imminent recession, the emergence of Chat GPT into the public consciousness had inspired buoyant sentiment across investment markets, as investors marvelled at the many ways this new technology might improve productivity and reshape the economic landscape.

AI, championed by Nvidia, imbued the investment landscape with an optimism that allowed markets to see through concerns of struggling consumers, slowing China and geopolitical conflict. The company's rise, has been truly astounding, gaining over 730% in the 21 months through to the end of September.

As is often the case, it took very little for markets to take fright. The 'Magnificent 7' had already begun to cede their market leading positions (Nvidia for instance briefly broke through $140 per share at the end of the prior quarter and has not since reached that high again). Such a loss of momentum was one half of the equation, with soft manufacturing and jobs data out of the US adding to investors' sense of trepidation. The second shoe to drop was a surprise interest rate hike from the Bank of Japan (BoJ), that triggered an unwind of the Yen carry-trade. Essentially, a large swath of investors had been borrowing in Yen, converting to US dollars and purchasing shares. As is the case with all carry trades, they're reliant of stable conditions. Compounding this, is the fact that the longer those conditions persist, the more crowded the trade becomes. With a slowing in gains for the equity side of the trade and an increase in the cost of the financing side of the equation, investors rushed for the exits. As the action of closing equity trades (essentially selling) pushed markets down, a self-fulfilling cycle emerged, further exacerbating the problem.

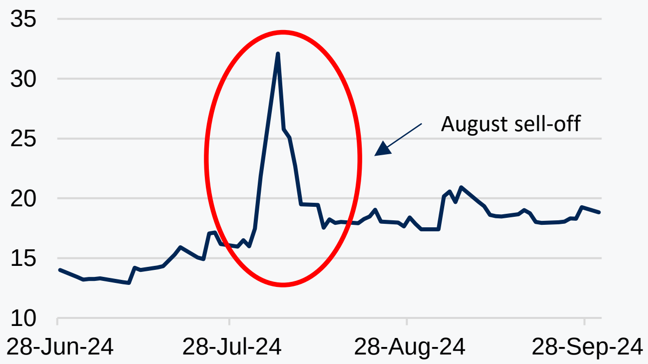
Fortunately, this sudden bout of volatility did not expose any previously unforeseen structural vulnerabilities. Within a week, share markets had found a floor and less than two weeks later, they had regained practically all of the drawdown.

Figure 4: Equity markets – a brief dip



Source: FactSet. Data as of 30 September 2024 and in local currency (LC) terms.

Figure 5: CBOE VIX – the market's 'fear' gauge



Source: FactSet. Data as of 30 September 2024.

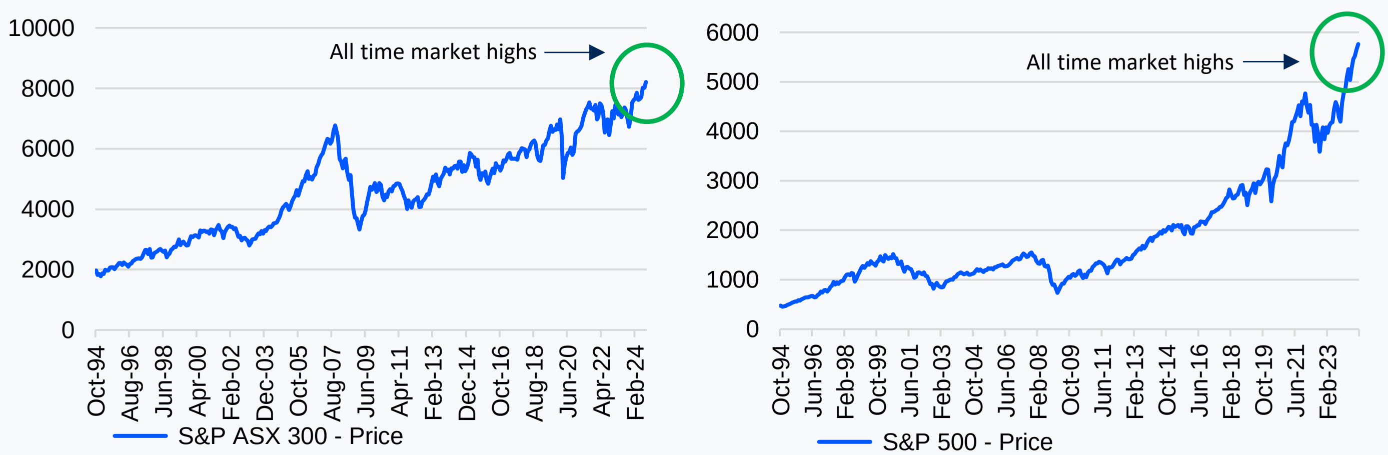
Whilst investors were left largely unscathed by the sharp burst of turmoil, the complexion has changed. One 'bubble' that popped over the period was that of AI sentiment. With so much money having been invested in AI chips (GPUs) and so much hope being placed in the transformative nature of the technology, there has been a lack of revenue being generated. This is a problem. When you're investing billions of dollars on AI infrastructure per quarter, and return on investment is not being reflected, doubts begin to emerge. It is telling that when Nvidia announced their results in late August, despite being higher than market expectations, the shares sold off. It is conventional market wisdom that when even good news can't inspire markets, optimism has crept too high. It was during this time we had leaders across the technology sector, including from Facebook (Meta) and Alphabet (Google), all coming out with statements about investors needing to be 'patient' regarding AI

Fortunately, September brought with it some respite with the US Federal Reserve seeing fit to cut interest rates for the first time this cycle. Notably, it was a 50-basis point cut, rather than the 25-basis point many economists had expected. Many people (us included) had been concerned that a 50-basis point cut would be seen as sign that the Fed's governors were worried about a far weaker economy than might be perceived by the market. Fortunately, and potentially due to some forward messaging having been disseminated to reduce potential shock, investment markets broadly took the announcement in their stride. There was a 24-hour period where markets swung, looking for consensus, but by the time the dust had settled, the joy of lower interest rates for businesses and consumers, was more in focus than any concerns regarding the Fed's forward insight of future economic weakness.

Changing market leadership

That markets have been so resilient has been both pleasing and confounding in equal measure. Having been exposed to the most rapid monetary tightening in history, following the first global pandemic in nearly 100 years, with the arrival of high levels of inflation, whilst facing growing conflicts in the Middle East and eastern Europe, it is curious that markets have generally been so strong. Many stock markets are at or near all-time highs and continue to push upwards. All whilst central banks (except notably our own RBA) see economic conditions as being suitably weak to justify a reduction in monetary tightness.

Figure 6: Australian and US equity markets reach all-time highs



Source: FactSet. Data as of 30 September 2024 and in local currency (LC) terms.

Whilst in the UK, Europe, and New Zealand, economic weakness is not debateable, the case of the US is not so clear cut. As the primary capital market on the planet, what happens in the US is critical for the rest of the world. As the saying goes, "if the US economy sneezes, the global economy catches a cold". As has been the case for some months now, data in the US, just as it has been here, has been refusing to give a clear signal of economic weakness or strength. One data point suggests weakness, before the next swiftly gives a signal of strength.

Equally curious, is the fact that there are many groups in economies that are not enjoying pleasant conditions. When we referred last quarter to the 'haves and have nots' it was clear that in the 'have nots' camp, there were a significant number of households (those with young families for instance), companies (smaller) and countries, that were not doing as well as others. Of course, this can change over time, but it is a key condition we are watching for, with a broadening of economic strength, across all these segments crucial for us to move to more decisive investment positioning.

What does appear to be clearly evidenced in the past quarter is a degree of sector rotation. The Technology[20] sector fell by 2.7% in the period, only to be outdone by Energy[21] (-5.8%) which was weighed down by the continued decline in oil prices. Conversely, Real Estate and Utilities were the best performers for the three months with gains of 12.4%[22] and 12.2%[23] respectively, giving some indications that whilst markets continue to march upwards, the baton of market leadership may have been passed from the more dynamic 'new economy' sectors, to traditional cyclical and industrial business types. While time will tell if this is sustained, in the short term, that Value[24] was able to generate a buoyant 5.5% over the three months, against Growth's -0.4% gives apparent credence to this belief, in that we might be seeing a change in the characteristics, if not the direction, of equity markets.

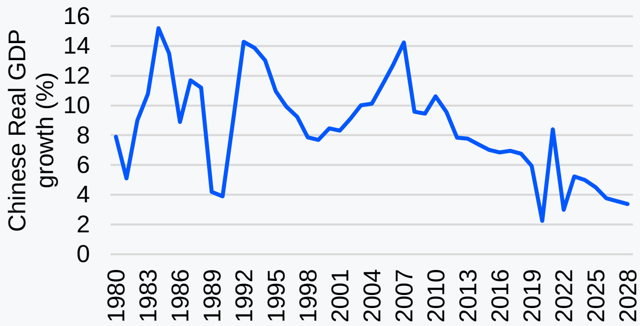
Hot taps vs cold taps

Moving forward, there are three primary areas that we see as being crucially important to investors; China, Geopolitics and Monetary Policy. Whilst they are influenced by a wide array of factors, and will feed into markets via different routes, they all have the greatest scope to impact future outcomes, for economies and investments alike.

1. China

For almost 20 years (and arguably longer) China has been a growth engine for the global economy. Following its "opening" and "reform" initiatives instigated by Deng Xiaoping in the late 1970s, China has led an impressive rise to being the second largest economy in the world. Indeed, only a few years back it seemed imminent that it would surpass that of the US. Unfortunately, the country's growth trajectory has significantly slowed in recent times.

Figure 7. Chinese Real GDP growth – a downward trend



Source: FactSet. IMF - World Economic Outlook.

Given the lack of transparency regarding fundamental economic data coming out of the country, it is difficult to be sure of the root cause of the malaise (for instance youth unemployment data was withdrawn then refactored when it refused to show what the CCP wanted it to). It could simply be that the Chinese economy has harvested all of the 'low hanging fruit' and the slowdown is simply a matter of the economy 'maturing'. To that point Chinese property, has been falling now for more than 3 years, giving up over 18% from the its peak in June 2021. With the construction sector being an important employer, it is easy to see how this could weigh heavily on the economy. Additionally, property tends to make up a significant proportion (c60-70%) of household wealth, driving lower demand from Chinese citizens, via the wealth effect.

Figure 8. Chinese Property – Bad for the economy, bad for consumer sentiment

Source: National sources, BIS Residential Property Price database

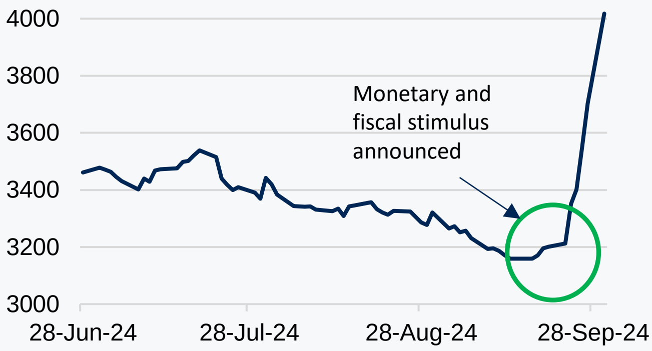
20 As measured by the MSCI AC World Information Technology index
21 As measured by the MSCI AC World Energy index
22 As measured by the MSCI AC World Real Estate index
23 As measured by the MSCI AC World Utilities index
24 As measured by the MSCI World Index Value index (AUD unhedged)

Having enjoyed much of its success as the 'workshop of the world', with an export lead economy, the country has been attempting to adjust its focus to domestic consumption; a dynamic similar to that enjoyed by the US However, the 'animal spirits' that can normally be relied upon in the behaviour of investors and consumers within capitalistic economies, appear to be largely absent in China in recent years. Whether that is linked to a negative wealth effect impacting consumer behaviour (households feeling less wealthy and therefore being less inclined to spend), or whether it is related to the litany of attacks on successful sectors that the Party has undertaken in recent years (Education, Gaming, Investment Banking, Management Consulting to name the most public) sapping confidence. What is clear is that the country is enduring a weakening business environment as consumers opt to save instead of spend, whilst at the same time, international investors are opting to avoid exposure, given the lack of transparency around policy measures and regulatory risk that is now exceedingly difficult to model.

Ultimately, it appears that the underlying problem may be more ideological than anything else. After years of enjoying success from 'capitalism with Chinese characteristics', under the leadership of President Xi, the country has explicitly moved away from this model. What the CCP and Xi appear to be ignoring and effectively eschewing, is the dynamism that a competitive economy with self-interested economic agents delivers. By punishing 'conspicuous consumption' and publicly shaming and or attacking successful industries and businesses, they may be killing or have killed, the capitalistic goose that has for so long, laid economic golden eggs.

Fortunately, that there is a problem, hasn't been lost on authorities and they have become increasingly forceful in their attempts to shore up the economy. Whilst we have harboured various views on why more action hasn't been taken previously, in the last week of September the Peoples Bank of China announced several monetary easing measures, including the biggest ever cut on its one-year policy loans. Following closely behind, the Politburo announced fiscal measures to further support and stimulate economic activity. These actions triggered a strong sense of optimism in Chinese equity(see Figure 9) markets with the CSI 300 (China's main stock market index) gaining 32.5% in just two weeks.

Figure 9. CSI 300 – Chinese markets exhibit optimism after more forceful stimulus announced

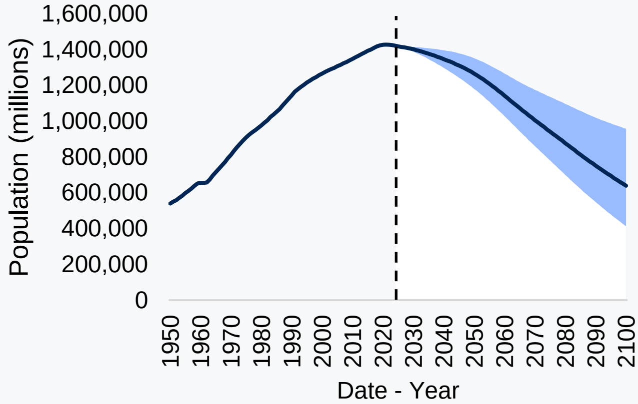


Source: Source: FactSet. Data as of 30 September 2024. Returns are calculated in local currency and net of fees.

Unfortunately, at the time of writing, the details on the fiscal measures has been disappointingly vague, with markets reflecting their displeasure in the largest one day sell of since the arrival of the pandemic, four and a half years ago.

Regardless of ideology, China does need to solve this problem soon. Not only does it seem to be tangled in the 'middle income' trap, it is also facing a daunting demographic problem in the years to come, with its working age population set to decline by a whopping 40% over the next 3 decades. Years of strict reproductive policy (such as the 'one child' policy) have led to this challenge and if they don't get out in front of it soon, they may never build up enough economic momentum to meaningfully counter this detrimental headwind.

Figure 10. Chinese population – a growing economic headwind



Source: United Nations - Department of Economic and Social Affairs

Whilst we have been underwhelmed by measures taken to date, we do expect them to increase and should authorities be able to rise to the challenge, an improving Chinese economy is likely to improve the global economy, with our own domestic economy sure to be a key beneficiary. We continue to monitor these developments closely.

2. Geopolitics/politics

Geopolitical tension remains elevated and likely to remain so for the foreseeable future. Whilst the invasion of Ukraine was the primary concern for an extended period of time, Hamas' vicious attack on Israel 12 months ago, triggered an increasingly escalatory conflict environment across the Middle East, arguably the worst in over 50 years. Indeed, Iran's barrage of 200 ballistic missiles fired at Israel, is unprecedented, with it and a larger but more 'telegraphed' attack earlier in the year, being its first direct attacks on the country in its history. Whilst many world leaders have been calling for restraint, the risk of further escalation remains high.

Although regional conflicts don't tend to impact investments over anything but the short-term, we could see some inflationary effects given the potential impact on oil markets. Whilst Iran is not as important a producer as it has historically been, producing approximately 3% of global output, it has strategic control of the Strait of Hormuz, through which some 20% of global supply travels.

Additionally, the US presidential election is looking to be an excruciatingly close race, based on present polls. Whilst the US has a long and proud democratic tradition, the rise of Donald Trump and populism in the country has made the political landscape the most fractious in modern history, with the January 6th, 2021, attacks on the United States Capitol Building, demonstrating a clear threat to what has been a reliably peaceful transfer of power. How this plays out matters, not only for the future of society in the US, and the US economy, but importantly, for the global world order. As the only true superpower now, any disfunction or withdrawal, real or perceived, from traditional alliances would likely encourage opportunism from those countries who seek to reduce the influence of the Western democratic liberal framework of alliances and economies.

Whilst still low probability, increasing degrees of conflict worldwide provides scope for risks to escalate, or (more likely) recede, depending on the various outcomes and how they interact.

3. Monetary policy

The focus of markets for almost three years now, has been on the actions of central banks, as they have worked to slay the inflation 'dragon'. Having increased interest rates at a historically rapid pace, our monetary authorities have been 'data dependent' for some time now, reading the economic tea leaves to determine if they had done enough or too much. Here we are reminded of economist Milton Friedmans' analogy of a 'fool in the shower'; a scenario that reflects the long and variable lags of monetary policy, as someone trying to find the right temperature in the shower, furiously spinning hot and cold taps, to try and get the balance right.

Pleasingly, it does increasingly appear that inflation has been largely tamed, with central bank discussion moving from pressure on prices to the health of labour markets. For some time now, we've been talking about the fact that inflation has gone from the only focus of central banks, to the main focus, to now a secondary consideration. Failing some form of shock, or an excessive rebound in economic strength (not impossible – the US economy has added 1 million new jobs in the last 6 months), we expect this trend to continue, with inflation continuing to move towards the targeted range and efforts focussed on getting the 'landing' right.

The right temperature

As we step through the closing months of 2024, there are clearly a raft of challenges for countries, economies and investment markets to contend with.

With the US Presidential election to be held on November 5th, we look forward to this key point of uncertainty to dissipate, with only concerns for a peaceful transfer of power to remain until the President elect is sworn in in January.

Economically the focus will be on whether there is a "hard", "soft" or "no" landing; ultimately whether inflation has been tamed without triggering a recession. At the present time, based on the timeliest data on hand, it is unclear which we will get, and we will continue to closely monitor the fine balancing act monetary and fiscal authorities seek to deliver, as they attempt to get the economic 'water' temperature just right.

The fact that we are seeing a healthy rotation within markets towards sectors that have lagged over the past few years is encouraging, as a broadening of the market rally is crucial to its continuation, as is the growing participation of smaller companies.

Pleasingly, the investment landscape is improving. It is a simple truism that markets 'climb a wall of worry', recognising that even the best returns come whilst there are serious challenges and concerns for investors. However, what drives our optimism is that our concerns all reside within the 'known unknown' space. Whilst as experienced market operators, we are always prepared for surprises, at the present time it appears that all major threats are front and centre, with governments and central banks keenly focused on delivering the best possible outcome.

As such, we look forward through year end and beyond, dedicating even greater consideration to how we can best position portfolios for the months and years ahead.

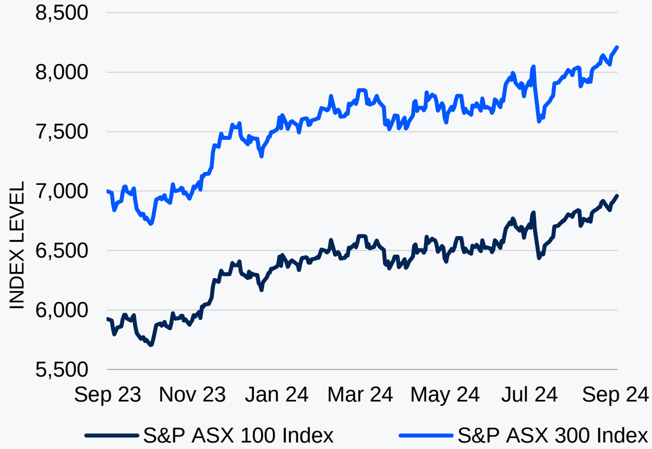
Australian equities

Australian equities experienced a stellar September quarter, marking the best quarter of 2024 and the strongest September - typically a weaker month for equity markets - since 2010. The ASX 300[25] reached 13 all-time highs, including on the final day of the period, capping off a remarkable turnaround from the sharp sell-off in early August. Despite the Reserve Bank of Australia (RBA) maintaining its monetary policy stance and resisting the global trend of rate cuts among other major central banks, Australian equities remained resilient. Domestically, inflation remains above the RBA's target, preventing the central bank from joining the broader monetary easing cycle. However, lower bond yields both at home and abroad, alongside the US Federal Reserve's 50 basis point rate cut and late-quarter surprise stimulus measures from China, provided tailwinds for the Australian equity market.

For the quarter, the ASX 300 posted a robust 7.8% gain. Larger companies (+7.9%[26]) outperformed smaller companies (+6.5%[27]), continuing the trend seen across global markets where larger firms benefit from economies of scale and better access to capital in a higher rate environment. However, in September, smaller companies (+5.1%) outperformed larger companies (+2.8%). Another notable rotation during the month of September was the outperformance of Value (+5.0%[28]) versus Growth (+1.0%[29]), reversing the pattern witnessed during the June quarter. Investors favoured more cyclical, value-driven sectors as market conditions shifted and bond yields drifted lower.

Sector performance was broadly positive, with nine of the eleven ASX 300 sectors delivering gains. Information Technology led the charge (+15.3%), closely followed by A-REITs (+14.3%), which benefitted from falling bond yields. After a challenging Q2, Materials (+10.8%) rebounded strongly, with a notable 13.0% one-month return in September, as China's stimulus efforts benefited Australian miners. Energy (-6.4%) was the weakest sector over the quarter, reflecting weaker global oil demand. Utilities (-1.2%) and Health Care (+0.6%) also lagged.

Figure 11: Australian shares – large companies



Source: FactSet, Perpetual Private

[25] As measured by the S&P/ASX 300 - Total Return Index
[26] As measured by the S&P/ASX 100 - Total Return Index
[27] As measured by the S&P/ASX Small Ordinaries - Total Return Index
[28] As measured by the MSCI Australia Value Index
[29] As measured by the MSCI Australia Growth Index

Australian equities – manager insights and outlook

As we entered the new financial year, we remained relatively cautious on the near-term path for equity markets. We hadn't seen any material pullback in share prices despite the pressure from persistent inflation, tight labour markets, and what seemed to be a "higher for longer" interest rate environment. From a valuation perspective, the share market was relatively fully priced. With the RBA's narrative on inflation and the path of interest rates evolving month by month, we could argue there may be tailwinds for either investment style; Value or Growth. As such, we began the quarter with a relatively style-neutral approach, given the shifting macroeconomic landscape. However, from a market capitalisation perspective, we continued to observe clear dispersion in returns, with sustained outperformance of large caps over small caps. Our view remains that there will be more opportunities and market inefficiencies outside of the large-cap index names. Particularly, as inflation stabilises and we inch closer to rate cuts, investors may rotate away from the safety of larger companies and into more opportunistic small-cap allocations. Therefore, we have maintained a slight bias towards SMID (small-to-medium) sized companies. At the sector level, key overweights included Tech, Healthcare, and Consumer Discretionary stocks, while key underweights were in Financials, Materials, and REITs.

The quarter began strongly, with the ASX 300 surging 4% higher in July, largely driven by softer inflation and labour market data. Despite a marginally positive return in August (+0.4%), it certainly was a much more eventful and highly volatile month. Early in the month, we experienced a sharp and indiscriminate sell-off on global equity markets as investors became concerned about the possibility of a US recession off the back of weaker jobs data, as well as some disappointing results from some of the mega cap tech companies and the Bank of Japan lifting interest rates to their highest point since 2007. However, markets recovered in the second week, supported by positive PMI and jobless claims data.

August also marked the beginning of reporting season. While company earnings for FY24 slightly exceeded expectations, all eyes were firmly focused on the companies' forward guidance for the year ahead, resulting in some downgrades to earnings revisions. Larger companies, with better access to capital, a more diverse business model and greater economies of scale, generally fared better than the smaller companies. At a sector level, Banks proved resilient and delivered on market expectations, while Technology stocks demonstrated robust customer demand and pricing power to sustain top line revenue growth. On the other hand, Resources and Energy sectors struggled due to increased costs, capital expenditure pressures, and falling commodity prices. The ASX 300 rallied a further 3% in September to close out the quarter up nearly 8%, and up nearly 22% on a 12 month basis. The portfolio notably benefited from an overweight to the Technology sector (+15.3%), with particularly strong returns from key holdings in WiseTech Global (+37%), Technology One (+28%), IRESS (+23%) and Life360 (+16%).

Our outlook from here remains largely unchanged. As we saw through the recent August sell-off, equity markets are particularly sensitive to central bank narratives on the path of inflation and interest rates. Post earnings season we've also seen a weaker earnings outlook, as companies grapple with higher costs and lower growth. While the RBA has played down the prospect of rate cuts this year, the market is pricing in 1% of rate cuts for the next 12 months. Despite potential interest rate cuts, which should favour growth stocks; the Australian share market across nearly all sectors (aside from Materials and Energy) is trading at near peak 12 month valuations (on a forward P/E multiple basis), and with sustained higher inflation, these data points would support Value stocks.

At this stage, we don't have a strong conviction on whether Value or Growth stocks will be favoured, so we remain broadly neutral on style. We expect continued volatility, which should benefit active managers with a bottom-up, fundamental approach, enabling them to capitalise on near-term stock price fluctuations by deploying capital to companies at attractive valuations. We also continue to maintain a slight bias towards SMID sized companies, as we feel there is greater opportunity to exploit inefficiencies within this pocket of the market.

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International equities

The September quarter saw continued appreciation for International shares, with the MSCI All Country World Index (ACWI) gaining a healthy 2.6% in Australian dollar terms. Indeed, the ACWI has now rounded out a 12 month return of 22.6%[30], despite a backdrop of high interest rates and under-pressure consumers. Nvidia, the leading edge of the AI thematic, actually lost value during the quarter; albeit a shy 1.7% having gained an impressive 36% in the three months prior. Indeed, one element of market behaviour which appears to have begun emerging across the quarter, is a rotation away from the businesses that have led markets for the past 18 months, and towards more income generating and cyclical sectors, who are more likely to benefit from monetary easing. The one exception to this, is the energy complex which, despite the most heightened levels of conflict in the Middle East in the past 50 years, has seen oil prices fall 16.9% in the period.

Aligned with this sense of a rotation across markets and away from the narrow, tech lead rally of the past couple of years, is the relative outperformance of smaller companies ('small caps') versus their larger counterparts. Traditionally seen as higher risk and higher reward, small caps have notably lagged over recent years, particularly during the recent rise of the 'Magnificent 7'. However, the September quarter saw small caps deliver a gain of 4.7%[31], a healthy 2.1%[32] higher than the broad market. Smaller company valuations continue to enjoy a relatively wide discount and are likely to benefit comparatively from lower interest rates.

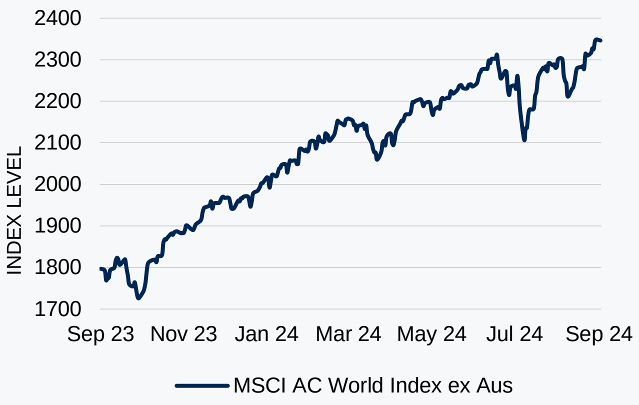
With the US Federal Reserve having held interest rates at 5.25-5.50% since July 2023, September 18th saw the first cut, a larger than expected 50-basis point. As such, it is unsurprising that traditional income generating sectors, Utilities and Real Estate, became the market leaders over the quarter, gaining 12.2%[33] and 12.4%[34] respectively. It is notable that the next best sectors, Financials and Industrials, enjoyed roughly half that return, returning a strong but much lower 6.5%[35] and 6.1%[36] respectively. At the tail end of performance, Energy, suffering from continued weakness in the oil price, lost 5.8%[37], whilst Information Technology suffered its first negative quarter in the past 12 months giving up 2.7%[38].

These tentative early signs of a 'changing of the guard' in global stock markets can most simply be viewed through the style lens of Value vs Growth. With Growth assets having clearly led the way over the past year (27.9%[39] vs 18.3%[40]), the quarter saw Value delivering 5.5% in gains whilst Growth, slipped back 0.4%.

30 In AUD terms
31 As measured by the MSCI All Country World Small Cap index
32 As measured by the MSCI All Country World index
33 As measured by the MSCI AC World Utilities index
34 As measured by the MSCI AC World Real Estate index
35 As measured by the MSCI AC World Financials index
36 As measured by the MSCI AC World Industrials index
37 As measured by the MSCI AC World Energy index
38 As measured by the MSCI AC World Information Technology index
39 As measured by the MSCI World Index Value index
40 As measured by the MSCI World Index Growth index

International equities – manager insights and outlook

Figure 12: International shares (local currency terms)



Source: FactSet, Perpetual Private

International equities – manager insights and outlook

As alluded to above, Q3 2024 appears to have delivered a 'regime change' of sorts with equity market leadership shifting away from 'Growth' stocks, and towards 'Value' stocks. Furthermore, and despite it being short-lived, we saw small caps show signs of life at certain junctures.

Despite the shift, the market appears to be wedded to the 'soft landing' narrative. This, at least partially explains the higher price-to-earnings ratios evident in markets at the moment, even as the macroeconomic data continues to be mixed. As at the time of writing, markets appear to be pricing several 'hard and fast' interest rate cuts by the US Federal Reserve. Given the Fed's noted shift towards the state of the labour market, and recent strong labour market data, we think the market is pricing more rate cuts than are likely to eventuate (if the current trend remains intact).

Given these dynamics, we are focused on the nexus between valuations and revenue/earnings outcomes. As markets extend their rally, we consider corporates' 'margin for error' in terms of revenue and earnings outcomes to narrow markedly. Misses are likely to see the trend of sharp drawdowns on specific stocks continue. We believe that avoiding names where this risk is elevated will be key to delivering strong outcomes.

As it relates to the mega-cap names, during the quarter we saw the US Department of Justice launch an anti-trust case against Google for monopolistic behaviour in online search, and subpoenaed Nvidia looking to ascertain whether the company had engaged in anti-competitive behaviour as it relates to its position within the AI ecosystem. We'll be watching these developments with interest.

Last quarter we spoke about the opportunities we saw outside the large and mega-cap segment of the market, which had been left behind in the rally over the last 12 months. This quarter we saw strong positive movements from those sectors that are considered interest rate sensitive (REITs and Utilities) and those that are more linked to the macroeconomic cycle (Industrials and Materials). We see value in these sectors, and should the expected 'soft landing' eventuate, it would be reasonable to expect an upswing in the profit cycle for the associated companies, supporting a further rally. European stocks, and small caps remain relatively cheaper compared to US and large-cap stocks, respectively. A broadening of the current rally and a 'soft landing' should support these exposures.

Real estate

Real Estate Investment Trusts (REITs) were the best-performing asset class in Q3 2024. This strong performance was primarily driven by a global decline in long-term bond yields, as investors responded to widespread monetary easing. Notably, the US Federal Reserve cut rates by 50 basis points throughout the quarter, contributing to a global interest rate-cutting cycle. The resulting decline in bond yields bolstered cap rates - a key measure in the REIT sector akin to an investment yield. After years of pressure from rising rates, cap rates are now acting as a tailwind for the asset class.

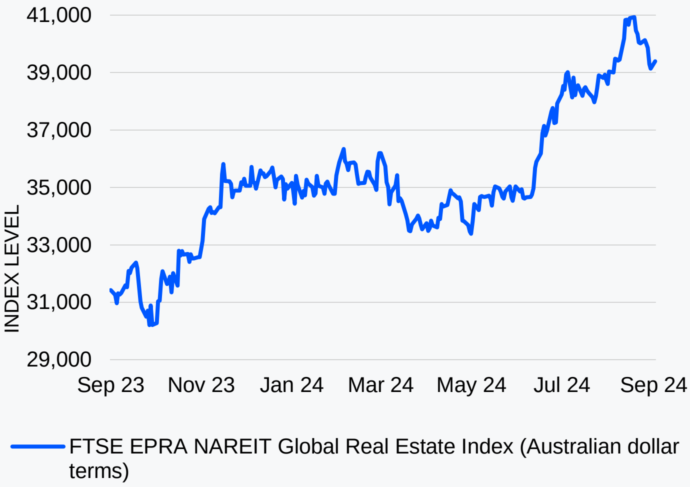
Australian REITs (A-REITs) delivered a robust return of 14.3%[41] during the quarter, and a remarkable 45.9% over the past twelve months. Global REITs (G-REITs) also performed well, returning 11.7% for the quarter and 19.9% over the year.

Several sectors contributed to this positive performance. The office sector benefited from a more optimistic outlook and greater clarity over prices with a rise in transaction activity. Additionally, the retail sector, which constitutes a substantial portion of the G-REIT index, performed well as consumer spending was better than expected in key geographies.

Figure 13: Australian Real Estate Trusts (A-REITs)

Source: FactSet, Perpetual Private

Figure 14: Global Real Estate Investment Trusts (G-REITs)



Source: FactSet, Perpetual Private

[41] As measured by the S&P/ASX 300 A-REIT - Total Return Index
[42] As measured by the FTSE EPRA Nareit Developed - Net Return Index (AUD unhedged)

Real estate – manager insights and outlook

Listed real estate benefitted from the US Federal Reserve's 50 basis point rate cut and the prospect of further cuts by year-end. With rates rises seemingly at an end, cap rates appear to be stabilising. With this comes a rise in transaction activity, particularly apparent in Australia with major sales at 255 George St and 5 Martin Place contributing to re-pricing in the office sector. This will continue to play out in a divergent pattern across sectors which are operating in different stages of their market cycles but should be broadly positive overall. Regional disparity is likely to persist, however, Chinese stimulus near quarter-end should support Hong Kong, while Japan may lag as the only major region forecasting rate rises.

Throughout 2024, we have sought to keep cash holdings to a minimum due to the sector's positive outlook. We have also allowed a slight domestic bias to run driven by the strength of some of the major companies in the local market.

In this buoyant environment, most sectors posted gains, though accommodation - hotels and residential - while positive, lagged behind. Some of the best returns globally came from lesser quality, more highly leveraged names. The few cases of significant price declines were associated with negative earnings announcements and in the case of Lifestyle Communities, pending legal dispute and the withdrawal of future guidance. We've previously discussed Equinix, which has nearly recovered to its March peak, outperforming other operators this quarter. It has also stayed out of the news cycle, a positive development for the company.

In Australia, Charter Hall was one of the strongest stocks, a prospective beneficiary from a resumption of transaction activity. Meanwhile Goodman Group lagged the market despite a positive operating environment as asset values adjusted lower and industrial demand slowed.

The strength of the price appreciation over the quarter has been surprising but the direction of the move was not given the evolution of inflation and interest rate dynamics. This has been a very positive environment for the sector and may persist but further moves of this magnitude are unlikely. As alluded to earlier, the sectors and to some extent regions, are moving through different stages of the cycle. The office sector is closer to a trough while retail is growing. Industrial remains strong but is starting to decelerate. Japan's interest rate path presents a risk, but Asia broadly could benefit from a recovery in China. At a more granular level, we remain of the view that office valuations may adjust further but this is a significantly diminished segment of the market and the bulk of valuation decline is behind us. Industrial rental growth should continue to slow.

Alternatives

Growth alternatives

The September quarter presented a mixed picture for Growth Alternatives, with traditional asset classes continuing their rally while unlisted assets experienced more subdued performance.

Within Infrastructure, we observed softening demand, with deals taking longer to attract buyers and pricing becoming less aggressive due to the higher cost of debt. However, infrastructure's role in the portfolio remains clear; to provide consistent and stable cash flows, and inflation-hedging properties. We are comfortable with our exposure to regulated assets and grateful for their contribution during the recent inflation spike. We are actively seeking to increase our exposure to volume-linked assets with strong cash flow profiles that can deliver attractive returns in the current environment. To that end, the Growth Alternatives programme participated in its first infrastructure co-investment, which is showing early promise.

M&A activity was mixed during the quarter, with Reuters reporting that the Asia-Pacific region experienced the largest year-on-year increase, followed by Europe. In contrast, US deal activity remained subdued, influenced by the higher cost of debt and the upcoming Presidential election. Driving corporate activity is a continued desire from shareholders for simpler businesses, as well as a modest uptick in activist activity.

Despite the changing market dynamics, we remain steadfast in our approach to Private Equity, giving credence to acquisition valuation multiples, costs of debt and the manager's operational capability. On the latter, sponsors appear determined to invest in their operational capability to drive operating performance. Furthermore, we are increasingly seeing dispersion across acquisition multiples for sponsored transactions across the US, Europe and Japan.

Real estate markets continued to exhibit turbulence, with transaction volumes remaining weak despite a modest pickup. Sentiment among institutional investors towards real estate allocations remains tepid. However, we anticipate that the magnitude of mark-downs will moderate throughout the remainder of 2024, potentially leading to increased deal activity later in the year and into 2025. We are particularly focused on opportunities arising from the current market dynamics. As some investors seek liquidity, we are seeing real estate funds being offered at attractive discounts to their prevailing net asset value (NAV). The breadth of our relationships with real estate managers positions us well to understand the underlying pool of assets and underwrite these opportunities to attractive valuations/entry points.

We continue to observe dispersion within equity and credit markets, as well as divergence in the macroeconomic conditions across different economies. While our credit-based exposures have performed well in recent quarters, tightening credit spreads have reduced the attractiveness of new opportunities in this space.

The evolving market dynamics, including shifts in inflation, interest rates, and economic indicators, require us to continuously reassess our outlook and portfolio positioning. During the quarter, we focused on refining our pipeline of potential investments for the coming 6-9 months, actively conducting due diligence on a number of differentiated ideas that are uncorrelated with our existing exposures.

Income alternatives

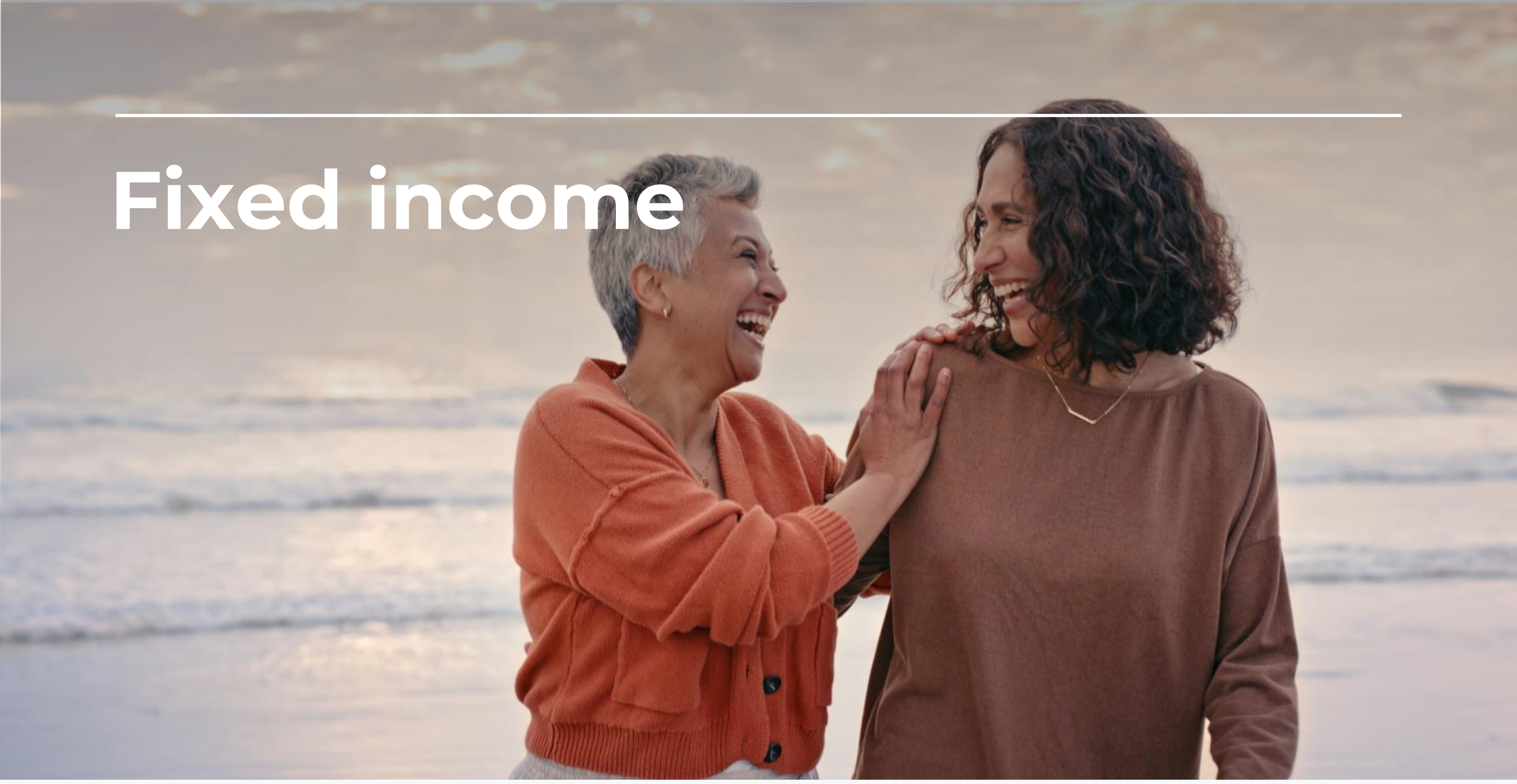
Market sentiment remained broadly positive in Q3 2024, with demand outstripping the supply of private credit. M&A activity in the corporate sector remained sluggish and thus was not conducive to private credit formation. We estimate that 90% of private debt activity is still refinancing existing deals as opposed to the growth of new credit opportunities. This strong market technical meant that credit spreads in the private credit space continued to compress while increased leverage by private companies remained well supported.

Default rates, while marginally higher, are still below the long-term average. Outside of an exogenous shock, we believe the private credit markets will continue to remain healthy. The interest rate cuts by the ECB and US Fed are broadly supportive of this trend. Falling interest rate costs are a net positive for corporate earnings and thus accretive to credit quality. However, given investor demand, we will likely see increased leverage by companies that can service ongoing interest payments.

Within the broadly syndicated loan space, there has been continued lender-on-lender violence as distressed investors continue to maximise returns at the expense of senior and subordinated lenders. We have not seen this type of behaviour in private credit markets yet, as the typical deal structure provides existing lenders with significant control, and the private nature of the deals introduces information asymmetry.

Asset-backed finance has continued to grow as an asset class as banks have pulled back due to higher capital requirements. These areas have historically been the largest component of bank balance sheets, but institutions have continued to cede market share as regulatory capital costs have affected the profitability of these segments. Compared to corporate lending, asset-backed finance remains less popular due to complexity, and thus spread compression has not had the same level of impact on this sector.

Over the quarter, we continued to deploy cautiously. We are less constructive on some segments of private credit given tighter spreads but are quite positive on asset-backed finance. We are currently exploring specific opportunities in structured credit and asset-backed finance but are maintaining our underwriting discipline given the complexity within the space. Within corporate loans, we are reviewing opportunities in mid-market lending but note that allocations will be made on an opportunistic basis.



Fixed income

During the September quarter, fixed income markets experienced robust performance, supported by falling inflation and a series of rate cuts by major central banks. This backdrop provided a favourable environment for both government bonds and credit, with bond markets rallying on expectations of further monetary policy easing.

Yields across the US and Australia fell significantly, with the US Federal Reserve cutting its benchmark rate by 50 basis points in September, marking the official start of its easing cycle. By quarter-end, markets were pricing in an additional two to three 0.25% cuts before year's end, suggesting another 50 basis points of reductions could come at either the November or December US Federal Reserve meetings. This marked a significant shift in sentiment compared to earlier in the year when the focus remained on inflationary pressures. Notably, the US 2-year Treasury yield dropped by 111 basis points to 3.64%, while the 10-year Treasury yield fell by 62 basis points to 3.78%. This steeper decline in the 2-year yield caused the yield curve to un-invert for the first time in over two years, signalling a shift in market expectations toward a less restrictive monetary environment.

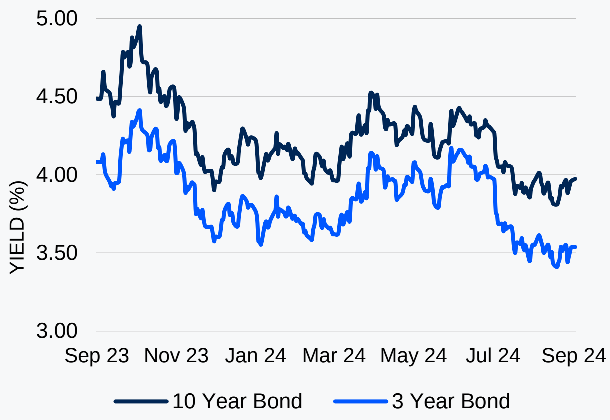
In contrast, the Reserve Bank of Australia (RBA) stood apart from the growing easing consensus displayed by developed central banks, abstaining from cutting rates as it continued grappling with above-target inflation. Despite this divergence, Australian bond markets still saw yields decline, with the 3-year government bond yield falling by 55 basis points to 3.54%, and the 10-year yield declining by 34 basis points to 3.97%. Elsewhere in the world, the European Central Bank (ECB) delivered its second rate cut in September, reducing interest rates to 3.5%, and the Bank of England (BoE) embarked on its own easing cycle, implementing a 25 basis point cut at its August meeting, as it navigated persistent wage inflations pressures in the UK.

Global bonds posted a strong return of 4.00%[43] for the quarter, with longer-duration bonds outperforming their shorter-term counterparts. Domestically, Australian bonds returned 3.0%[44] for the quarter, buoyed by a combination of falling yields and positive investor sentiment towards the asset class.

Credit markets delivered strong performance during the quarter. Corporate bonds outpaced government bonds, with credit spreads narrowing by quarter-end despite some volatility in July and August. Australian credit returned 3.1%[45], while US investment-grade credit posted returns of 4.9%[46], supported by investors seeking safety in higher-rated securities amid ongoing economic uncertainty. In the short-duration space, Bank Bills performed in line with the RBA cash rate, posting a 1.1%[47] return for the period.

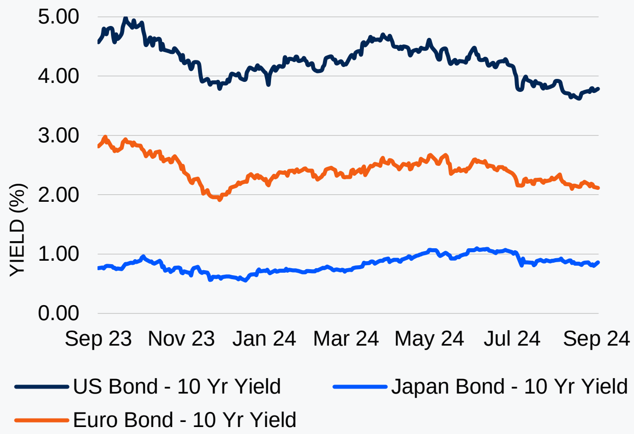
[43] As measured by Bloomberg Global Aggregate Bond Index (Hedged in AUD)
[44] As measured by Bloomberg AusBond Composite 0 +Yr Index
[45] As measured by Bloomberg AusBond Credit (0+Y)
[46] As measured by Bloomberg US Aggregate (AUD Hedged)
[47] As measured by Bloomberg AusBond Bank Bill

Figure 15: Australian government bond yields



Source: FactSet, Perpetual Private
Note: Bond prices are inversely correlated with bond yields.

Figure 16: Global government bond yields



Source: FactSet, Perpetual Private

Figure 17: Global credit markets

Source: FactSet, Perpetual Private

Fixed income – manager insights and outlook

Entering Q3 2024, we anticipated the divergence in inflation between Australia and other major economies would influence central bank policy and create opportunities within fixed income markets. This divergence played out as expected, with the RBA maintaining its cash rate while the Fed and other central banks began easing cycles. This led to increased volatility in government bond yields as investors reacted to economic data and adjusted their rate cut expectations. Specifically, Australian headline inflation remained stubbornly around 3.8%, contrasting with the US and Europe where inflation moderated below the 3% threshold.

While the easing cycle has begun, its magnitude remains uncertain. We believe that persistent inflationary pressures, potentially exacerbated by the upcoming US elections, geopolitical risks in the Middle East, and ongoing supply chain disruptions, could limit the extent of future rate cuts. Irrespective of who wins the US election, we expect increased US fiscal stimulus and tariffs on Chinese goods which can be structurally inflationary.

We are closely monitoring the potential for stagflation, which we believe remains a key risk over the longer term. In the short term, we are focused on the impact of weaker consumer spending and a potential corporate earnings recession.

Despite these concerns, credit spreads continued to compress throughout the quarter, driven by investors' ongoing search for yield. The strongest performing sector in the credit space was REITs despite the weak recovery in the property market. While we are wary of tight credit spreads and weaker fundamentals in some sectors, we acknowledge that this environment could persist, particularly given the recent interest rate cuts.

From a portfolio perspective, we remain broadly neutral on rates. While weaker consumer spending and a corporate earnings recession are positive for rate positions; the spectre of higher inflation over the longer-term is negative. In balancing the two potential outcomes, we continue to maintain a neutral position. Specific to credit we continue to keep our risk budget relatively low, leaning into exposures with shorter maturities which benefit from the high cash rate. We do not see the need to stretch for yield at the current time.

Australian cash rate

The Reserve Bank of Australia (RBA) held the cash rate steady at 4.35% during the quarter, with September marking the seventh consecutive meeting without a change. This decision reinforces the RBA's hawkish stance compared to other central banks, as it continues to prioritise combating inflation. Despite the ongoing pause, there was a notable shift in the RBA's tone. While the central bank maintained its view that inflationary pressures persist, it did not explicitly discuss the need for a rate hike at its September meeting, suggesting a potential softening in its hawkish stance.

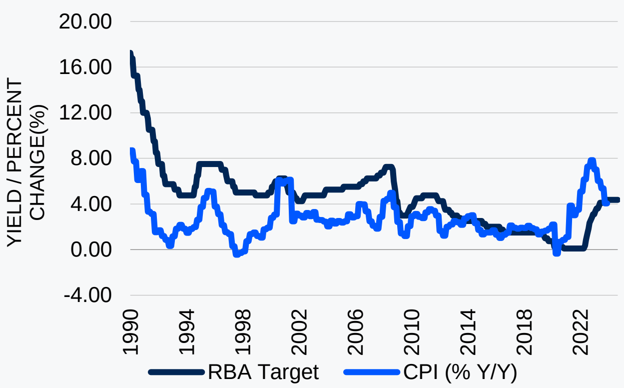
The August monthly consumer price index (CPI) report showed headline inflation falling to 2.7%[48] year-on-year, primarily due to the impact of government subsidies on energy costs. However, the RBA emphasised that these subsidies are distorting the underlying inflationary trend, which remains stubbornly high.

On the employment front, the August labour market report revealed continued strength, with 48,000 jobs added and the unemployment rate holding steady at 4.2%. However, consumer and business confidence surveys for August painted a less optimistic picture, highlighting growing pessimism across the household sector and suggesting a potential softening in economic activity.

Australian cash rate – outlook

Looking ahead, the RBA faces a delicate balancing act. It must weigh its mandate to control inflation against the need to support economic growth and maintain a healthy labour market. Governor Bullock has emphasised the importance of remaining vigilant on inflation, signalling that the RBA will be closely monitoring various economic indicators, including wage growth and consumer spending, to assess the need for any future policy adjustments. The RBA will also be keeping a close eye on the labour market, which has shown signs of softening despite remaining relatively tight.

Figure 18: Long-term cash rate vs inflation



Source: FactSet, Perpetual Private.

While financial markets are pricing in a potential rate cut by year-end, the RBA has indicated that any easing is unlikely before early 2025. This suggests that the central bank is prepared to keep rates higher for longer to ensure that inflation returns sustainably to its target range.

The RBA's cautious approach reflects the uncertainties surrounding the economic outlook. Global geopolitical tensions, a potential slowdown in China's economy, and the lagged effects of past rate hikes all pose challenges for policymakers. The central bank will need to carefully navigate these complexities in the coming months, adjusting its policy settings as needed to achieve its objectives of price stability and full employment.

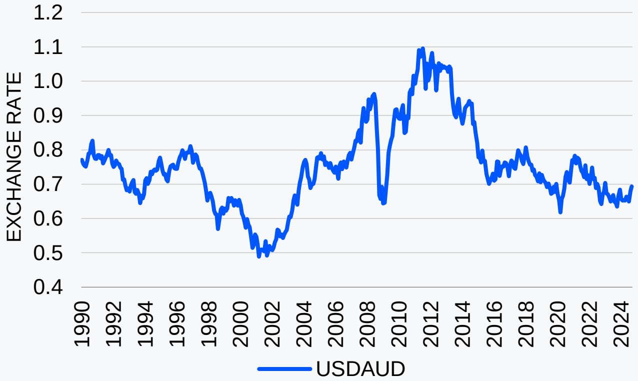
[48] Australian Bureau of Labour Statistics

Australian dollar

The Australian dollar continued its ascent in the September quarter, appreciating against the US dollar. This strength was driven by the RBA's decision to maintain its cash rate while other central banks, including the US Federal Reserve, embarked on easing cycles. This divergence in monetary policy narrowed interest rate differentials, making the Australian dollar more attractive to investors.

Over the quarter, the Australian dollar rose by 3.9% against the US dollar, reaching AUD 0.69[49] - its highest level of the year. This appreciation was further supported by a broad weakening of the US dollar, which fell by 0.9% on a trade-weighted basis against a (trade weighted) basket of currencies due to the Fed's larger-than-expected rate cut and expectations of further easing. In another notable development, the Japanese yen (JPY) appreciated against most major currencies, including a 7.6% rise against the AUD. This broad JPY strength was driven by the Bank of Japan (BOJ) tightening its monetary policy, leading to a narrowing of policy rate differentials against other major economies..

Figure 19: Australian dollar US dollar (daily) long term



Source: FactSet, Perpetual Private.

Australian dollar outlook

We typically refrain from making near-term forecasts for the Australian dollar, as currency movements can be particularly susceptible to short-term factors and momentum shifts, making accurate predictions challenging.

However, looking at the medium to longer term, we maintain our view that the Australian dollar is undervalued on a long-term purchasing power parity basis. In addition, recent developments in China could provide a further tailwind for the Australian dollar. The Chinese government's commitment to reenergising its equity and property markets through various stimulus measures is expected to boost economic activity and investor sentiment, which would benefit Australia as a major commodity exporter.

While the Australian dollar faces potential headwinds from global economic uncertainties and a potential slowdown in domestic growth, we believe that the current positive momentum, combined with supportive fundamentals, could see the Australian dollar continue its upward trajectory over the medium term.

49 FactSet. Data as of 30th September 2024

Authors

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Andrew provides investment research, portfolio construction and bespoke investment advice for Perpetual Private’s clients.

Andrew works closely with advisers by providing specialist investment knowledge on Perpetual’s investment process and strategy implementation, focusing on delivering optimal solutions to our stakeholders and partners. This is further augmented by his provision of transparent and accessible knowledge of financial markets and asset classes both globally and locally.

Having spent 15 years in London, Andrew returned to Melbourne with a wealth of international experience to benefit Perpetual’s clients and partners. Having started his career working on private equity transactions and stock market listings, he then spent time working on equity trading desks, before moving into investment management. In his role as a Portfolio Manager for Barclays Investment Solutions, Andrew managed money across multiple asset-classes on behalf of various client groups, before focusing on the charity and not-for-profit segment. With responsibility for as much as £3bn in assets, he developed a strong reputation for delivering robust investment performance linked to his comprehensive understanding of global investment markets.

Andrew is a holder of the Chartered Financial Analyst and the Chartered Alternative Investment Analyst designations

Hugo Goode, CFA
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Hugo is an Investment Specialist at Perpetual Private, where he joined the Investment Research Team in October 2023. He supports the Head of Managed Accounts and Perpetual Private Investment Directors by developing and maintaining investment content and collateral. He also helps communicate Perpetual Private's investment offerings to advisors and intermediary sales teams, representing the Multi-Manager and Direct Equities teams.

Before joining Perpetual, Hugo gained valuable international experience working as a Research Analyst for a wealth management firm in Vancouver, Canada. During his four years there, he focused on strategic and tactical asset allocation for high-net-worth clients across diverse asset classes and client profiles. Prior to his time in Canada, he held roles in Sydney at BT Financial Group as a Customer Relations Consultant and TP ICAP as a Trainee Broker.

Hugo is a CFA charterholder and holds a Bachelor of Commerce degree, majoring in Finance and Accounting, from the University of New South Wales.

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