THE JANUARY EFFECT

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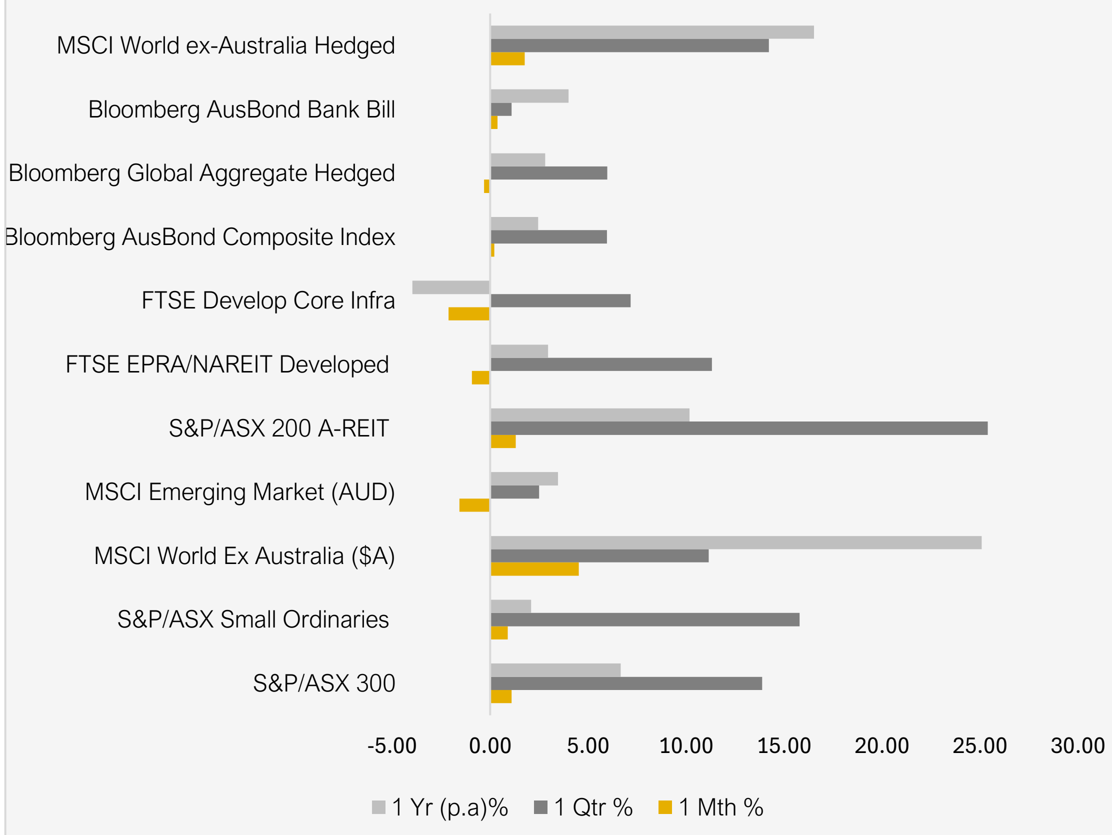
ECONOMIC & MARKETS COMMENTARY & OUTLOOK

- Markets wrap up – Most asset classes edged higher in January, in a continuation of the rally of late 2023, but with less optimism. However, some commentators may have got ahead of themselves, and excitement around potential interest rate cuts in May has now been moderated to later in the year. This led to a temporary setback for markets in mid-February, but if the downward trend in inflation continues, markets should perform well in 2024. Tax cuts in the middle of the year and falling interest rates should boost household consumption.
- The ASX 200 gained 1.2% in January, largely driven by the consumer discretionary and technology sectors, while the materials sector was a detractor due to reduced Chinese demand. The MSCI World index returned 4.5% in January with Japan making a significant contribution. Semiconductor companies contributed to gains while Chinese stocks struggled.
- RBA notes high inflation, aims for target, monitors global economy – The RBA's view is still that inflation is high but has noted that it is falling. The RBA is determined to return inflation to target and is paying close attention to developments in the global economy.
- Australia's unemployment rate ticks up – The seasonally adjusted unemployment rate rose by 0.1 percentage point to 4.1 per cent in January, according to data released by the Australian Bureau of Statistics (ABS). Employment remained stable with the number of unemployed increasing by 22,000 people. This was the first time in two years, since January 2022, that the unemployment rate had been above 4 per cent.
- Earnings Season starts strong despite higher rates, slowing economy– Earnings Season has kicked off with results surpassing expectations, suggesting that corporate profitability remains strong despite higher interest rates and a slowing economy.
- Inflation down to 4%, rates peak, Fed signals no changes – US inflation continued to fall (from 7+% a year ago to around 4% now), interest rates appear to have peaked, the US Federal Reserve appears to have moved from a tightening bias to signalling no changes, and the discussion from economists has moved on to the timing of rate cuts.
- Market cautiously optimistic despite geopolitical tensions, election risks – Despite the persistent challenges posed by Middle East tensions, the Ukraine conflict, upcoming key elections, escalating tensions with China, and the associated concerns in their respective property markets, the prevailing sentiment in the market is one of cautious optimism.

MARKET INDICES PERFORMANCE

INDEX Period ending 31 January 2024	Mth %	Qtr %	1 Yr %	3 Yrs. % p.a.	5 Yrs % p.a.	10 Yrs % p.a.
Australian Shares						
S&P/ASX 300	1.10	13.89	6.66	9.27	9.67	8.36
S&P/ASX Midcap 50	-2.17	10.6	-0.53	6.62	10.32	11.44
S&P/ASX Small Ordinaries	0.9	15.80	2.10	1.33	5.44	6.4
International Shares						
MSCI World ex-Australia	4.52	11.16	25.09	13.62	13.68	12.31
MSCI World ex-Australia Hedged	1.77	14.23	16.54	8.21	10.47	10.03
MSCI World ex-Australia Small Cap	0.38	11.54	10.17	6.44	9.18	9.73
MSCI Emerging Markets	-1.57	2.50	3.47	-2.8	2.99	5.76
Listed Property & Infrastructure						
S&P/ASX 200 A-REIT	1.31	25.40	10.18	7.60	5.09	9.25
Global Real Estate Index: FTSE EPRA/NAREIT Developed	-0.92	11.32	2.96	5.18	1.87	6.08
Global Real Estate Index: FTSE EPRA/NAREIT Dev Hedged	-3.43	13.97	-3.53	0.72	-0.69	4.08
Infrastructure Index: FTSE Developed Core Infrastructure	0.61	4.14	2.59	8.11	6.46	8.64
Infrastructure Index: FTSE Developed Core Infrastructure Hedged	-2.12	7.18	-3.97	3.37	4.40	7.68
Australian Bonds						
Bloomberg AusBond Composite 0+ Years	0.21	5.96	2.45	-2.49	0.56	2.55
International Bonds						
Bloomberg Global Aggregate Hedged	-0.31	5.98	2.82	-3.02	0.23	2.43
Australian Cash						
Bloomberg AusBond Bank Bill	0.37	1.09	4.00	1.83	1.44	1.79

RELATIVE PERFORMANCE - JANUARY 2024



INVESTMENT OUTLOOK

- How much of a difference a year in the markets makes – One year ago, many market experts were predicting an increased risk of a U.S. recession and, to a lesser extent, the Australian economy entering a downturn. This anticipation was supported by the inversion of the yield curve, a robust indicator of an impending economic downturn. Additionally, concerns escalated as the Federal Reserve implemented a series of aggressive interest rate hikes, marking the most substantial increase since the 1980s, totalling 450 basis points over the past 18 months. Meanwhile, Australia's Reserve Bank (RBA) also raised rates by 400 basis points during the same period.
- Approaching market consensus with careful consideration – While we did recognise the growing risks of recession, we didn't have the same level of pessimism as the consensus earlier in 2023, highlighting the resilience of global economic growth, the strength of employment data & wages growth, manageable debt levels, solid consumer & corporate balance sheets.
- Possibility of a more broader market upswing in 2024 - In the 2023 calendar year, both Australian and global equity markets witnessed double-digit returns. Notably, the S&P 500 surged by more than 21%, primarily driven by the outstanding performance of a select group of stocks known as "the Magnificent Seven" – comprising Apple, Amazon, Alphabet, NVIDIA, Meta, Microsoft, and Tesla – which collectively boasted a remarkable 70% year-to-date increase. Even excluding these stocks would still leave the S&P 500 with a respectable 6% gain. This pattern of concentrated outperformance has persisted for nearly a decade. Looking ahead to 2024, there is potential for a more widespread rally in equity markets, particularly from sectors and sub-asset classes that have lagged behind these narrow high performers.
- A significant shift in Central Banks' narrative going into 2024 – Several Central Banks have shifted their stance, with the US Federal Reserve being notably more dovish that previously. During the recent Federal Open Market Committee (FOMC) meeting, the Fed declared its decision to keep rates within the range of 5.25% - 5.50%. They emphasized a slowdown in growth and inflation, indicating that the previously elevated interest rates have accomplished their intended outcomes. The meeting minutes hinted at potential future rate reductions, but ongoing discussions are still underway regarding when and how significant these cuts should be. Presently, market expectations are aligned with the anticipation of three to four rate cuts in 2024, leading to a retreat in the bond market. On the other hand, the European Central Bank (ECB) and Australia's Reserve Bank (RBA) are adopting a more cautious approach in their policy trajectories, not aligning as closely with the dovish stance of the Fed.
- US double-digit earnings expectations through CY 2024 – Despite concerns about a potential economic downturn in the coming year, analysts anticipate robust double-digit earnings growth in the S&P 500 for the calendar year 2024. Projections suggest an estimated year-over-year earnings growth rate of 11.8%, surpassing the trailing 10-year average annual earnings growth rate of 8.4%. Looking at the quarterly projections, analysts foresee substantial earnings growth in Q4 2024 specifically, with an impressive growth rate of 18.2%. All eleven sectors are expected to demonstrate year-over-year earnings growth in 2024, with five sectors expected to achieve double-digit growth, led by Health Care, Communication Services, and Information Technology. While expectations might seem optimistic, even if half of these projections materialise, they should provide support for equity markets.
- Valuations of equity markets suggest markets are already pricing a soft landing – In the U.S., the current valuation sits at 18 times earnings, slightly exceeding the long-term average of 17 times. Conversely, the Australian equity market aligns with its historical average valuation of 15 times earnings. These valuations indicate a level of optimism and suggest a smooth landing in the short-term. Notably, some Emerging Market valuations appear attractive.
- China's economy is finding stability amidst challenges – China's economy seems to be stabilising in response to incremental stimulus measures. The projected growth rate for the Chinese economy is expected to slow to a solid 4.6% in 2024, following a rebound of 5.4% in 2023. However, challenges in the debt and property markets are expected to persist, posing a hindrance.
- Global economic and equity market risks endure – The possibility of a recession cannot be wholly disregarded, given uncertainties related to depleting household savings, the potential effects of escalating interest rates on consumers, and emerging hurdles in refinancing.

INVESTMENT STRATEGY

- The importance of an active Asset Allocation strategy – In this highly volatile market environment, maintaining an active and nimble asset allocation strategy is crucial. This strategy enables us to capitalise on opportunities and promptly mitigate risks. Currently, we lean towards holding above-normal cash levels in most portfolios, allowing us to capitalise on real and attractive opportunities as they arise.
- Australian and Global Small-Cap Stocks an appealing investment prospect – Small-cap stocks have faced challenges due to the high interest rate environment, elevated borrowing costs, restricted credit access, and concerns about a potential recession. Smaller companies also encountered difficulties passing on increased costs, lacking the pricing power exhibited by larger-cap companies, impacting earnings. We anticipate a reduction in return dispersion over time as elevated inflation subsides, interest rates reach their peak, and recession risk diminishes. Consequently, Activam perceives small-caps as attractive from a valuation perspective. While large-caps seek growth, small-caps offer access to growth, making them attractive from a Mergers & Acquisitions standpoint.
- The potential for an upward movement of the Australian Dollar against the US Dollar – The AUD is currently trading at 65 US cents, well below its long-term average of 85 US cents. The Australian dollar is expected to benefit from continuing stimulus measures in China, considering China accounts for a third of Australia's exports. As the US approaches the peak of its interest rate hike cycle while Australia is still behind in this trend, the narrowing of interest rate differentials should also benefit the Australian dollar. Activam believes that the US Federal Reserve is more likely to engage in a potentially rapid easing cycle by cutting rates more aggressively due to a slowdown in economic growth. Australia might follow a similar pattern later. This should favour the Australian dollar relatively speaking. Given the supportive factors for a stronger AUD, Activam holds a positive outlook for the AUD against the USD on the upside. Therefore, we recommend increasing the currency hedge from 30% to approximately 60% within the International Shares asset class.

INVESTMENT STRATEGY (cont'd)

- **A-REITs and G-REITs asset classes could see relief in the near future** – Both Australian Property (A-REITs) and International Property (G-REITs) asset classes faced significant challenges over the past eighteen months compared to the broader equity markets. Several factors contributed to the underperformance, including rising interest rates and associated rising debt costs, growing pessimism regarding real estate prices, and the impact of work-from-home arrangements on the office space sector. Given this poor performance, and some evidence of a turnaround, these asset classes now appear attractive from a valuation perspective, particularly as A-REITs are broadly trading at a discount to their net asset value (NAV). As we continue to witness softening inflation in both the US and Australia, and with bond yields falling, Activam believes that these factors would serve as tailwinds for both the A-REITs and G-REITs asset classes going forward.
- **The increasing appeal of the Fixed Interest asset class** – Interest rates in Australia have risen 13 times within a 15-month period, reaching the current cash rate of 4.35%. Similarly, in the US, the Fed has increased its rates 11 times since March 2022, raising the Fed Funds Rate to a range between 5.25% and 5.50%. This rate stands as the highest level in 22 years. Given the recent slowdown in inflation readings, along with a softening in the labour market and decreasing wage pressures and consumption levels, both the US and Australia are moving their interest rates closer to their current cycle peaks. Therefore, we anticipate reduced downward pressure on bond returns. Activam sees this as an opportunity to reduce cash in the portfolios and reallocate the proceeds to the more attractive fixed interest asset class.
- **Maintaining a near-neutral stance on exposure to Emerging Markets** – Emerging Market equities have significantly underperformed broader Developed equity markets for the last few years. While Emerging Markets equities valuations appear more attractive relative to Developed Markets, underlying fundamentals, such as slowing consumer consumption and manufacturing production, credit growth, falling exports, as well as a weakened property sector may continue to act as headwinds. Consequently, adopting a more neutral exposure to the Emerging Markets asset class offers the potential for upside in portfolio returns.
- **Expectation of high-quality Alternatives to persist in delivering diversification benefits** – Asset classes with low correlation, such as private equity, have proven their capacity to generate attractive returns in rising markets over the medium- to long-term, all the while providing protection against downturns.