Perpetual Private | Quarterly Market Update

A Delicate Balancing Act

How will a central bank conundrum, labour market resilience and narrow market leadership impact investors over the coming months?

March 2024

Trust is earned.

Perpetual

Contents

Snapshot

Markets have confidently climbed the proverbial 'wall of worry' over the past 15 months. Despite a backdrop of caution and some clear and obvious headwinds, asset values have predominantly marched forward, with positive sentiment becoming increasingly pervasive amongst investors. Indeed, the chances of a soft-landing continue to grow and the confidence this is generating is becoming self-fuelling.

When we reflect on the mid-1990s we can consider a period that shares some of the key characteristics that are present in today's economic landscape. Back then, central banks were able to deliver interest rate cuts, pivoting from being monetarily 'restrictive' to 'supportive' at a crucial point in time. That is the key question that occupies the minds of central bankers presently and they will undoubtably be cognisant of the successful timing of rate changes during that period. It is worth noting that of the past 17 tightening cycles in the US, only 2 have resulted in soft landings.

Given present circumstances, it is encouraging to recognise that circumstances and data are increasingly supportive of a soft landing. However, it is not the only possible outcome. It is a plain truth that most hard landings first must travel through soft landing territory. It is not for us however, to look a 'gift horse in the mouth'. As we have repeatedly stated, we have not been negative or pessimistic about opportunities in the current investment environment. It has been our contention that the changes occurring in economies and markets, have been generating many opportunities. However, we emphasize that forward visibility remains low. As such we retain a degree of caution, hinged on the basis that there are a number of situations yet to play out. As the oft quoted Yogi Berra once said, "predictions are hard, particularly about the future". It is our current perspective that not only is the future unknown (as it tends to be), but it is also presently unknowable. This is because the significant increases in interest rates have yet to be fully digested by investors and companies. The way in which this will play out, can take numerous different paths and it's not likely we'll know those paths until we're on them.

Looking out to the end of this financial year and beyond, we continue to assess opportunities with vigour. Experience tells us that when the right conditions present themselves, there will be many chances to enhance the long-term performance of the assets under our management. Although we do not feel the time is yet right to act forcefully, we anticipate that time is on the horizon, and it will be worth our efforts in standing ready to act on the concerted and disciplined due diligence we are currently undertaking across various market segments.

Asset class performance – March quarter

Australian equities

Building on the momentum from Q4 2023, Australian equities continued their upward trajectory in the first quarter of 2024, with the S&P/ASX 300 delivering a solid return of 5.4%[1]. This strong showing extends the index's gains over the past year to a remarkable 14.4%, significantly exceeding long-term averages. This buoyant sentiment mirrors the generally positive performance of global markets and aligns with expectations of a 'soft landing' being achieved.

The positive sentiment permeated the small cap space as well, with the S&P/ASX Small Ordinaries index expanding by an impressive 7.6%[2]. This growth was further fuelled by a surge in mergers and acquisitions activity.

Encouragingly, the strong performance wasn't just concentrated in a select few sectors. Industrials returned 7.2%[3], indicating that the rally is broadening. Real Estate was also another standout performer, returning an impressive 16.2%[4] for the quarter. Further signs of cooling inflation and hints of central bank rate cuts in the near future boosted the real estate market as median prices rose by 1.6% over Q1 2024, up from 1.4% in Q4 2023[5]. Consumer Discretionary (+13.3%)[6] was another beneficiary of investor's improved outlook on the economy.

At the heart of the rally over the last five months, both domestically and internationally, has been the boom in Information Technology. Although a relatively small weight in the S&P/ASX 300 index, the sector delivered a staggering 23.6%[7] growth in Q1, adding to its impressive 48.3% gain over the past year.

However, Materials bucked the trend, facing a double whammy of falling commodity prices and rising wages, resulting in it being the only sector in the red (-6.3%)[8] for the quarter. Communication Services was another sector whose performance lagged the broader index, returning 1.2%[9] over the last three months. Telstra's defensive nature, which makes up nearly half the sector (49.5%), was less appealing to investors in a pro-cyclical market. Consumer Staples also lagged, posting a return of 2.1%[10], as 'expensive defensives' were out of favour with investors.

Continuing a familiar trend, Growth once again outperformed Value, recording a return of 7.7%[11] compared to Value's 3.0%[12] over the quarter. Aligning with the top-performing sectors, optimism surrounding the potential of Artificial Intelligence technology fuelled investor interest in growth stocks.

1 Measured by the S&P ASX 300 Index
2 Measured by the S&P ASX Small Ordinaries
3 Measured by the S&P ASX 300 Industrials
4 Measured by the S&P ASX 300 A-REIT Index
5 Core Logic Australia
6 Measured by the S&P ASX 300 Consumer Discretionary
7 Measured by the S&P ASX 300 Information Technology
8 Measured by the S&P ASX 300 Materials
9 Measured by the S&P ASX 300 Communication Services
10 Measured by the S&P ASX 300 Consumer Staples
11 Measured by the MSCI Australia Growth
12 Measured by the MSCI Australia Value

International equities

The 2023 end-of-year rally continued and accelerated in the first quarter of 2024, driven by optimism about stable global growth, falling inflation, potential central bank rate cuts, and continued AI enthusiasm. Investors remained confident that the global economy is headed for a "soft landing." International equities on an unhedged basis (MSCI All Country World Index +13.2%) outperformed Australian equities over the quarter, boosted by a weakening Australian dollar (down 4.4% against the USD).

Unlike Q4 2023's US tech-led rally, the March quarter witnessed a much more balanced rally with gains distributed more equitably across geographies, sectors, and industries. Most major equity indices reached or neared all-time highs during the period. While the U.S. remained strong (S&P 500: +15.5%, NASDAQ: +14.3%)[1], other global indices like the German DAX (+12.9%) [2], Japanese Nikkei 225 (+18.2%) [3], and French CAC (+11.4%)[4] posted impressive gains. Foreign developed markets outperformed emerging markets (7.1%)[5] due to better economic data, expectations of early summer rate cuts from major central banks, mixed Chinese economic data and a lack of substantial Chinese economic stimulus early in the quarter.

Small Caps continued to lag Large Caps (8.7% vs 13.2% in AUD)[6], with high interest rates continuing to weigh disproportionately on smaller names, given they are typically more sensitive to higher funding costs and concerns about slowing growth. However, there are signs of momentum building in smaller companies.

Growth (+15.3%)[7] again edged out Value (+12.4%)[8], albeit with Value beginning to show some signs of building momentum. Continued AI enthusiasm drove Growth's slight outperformance, but the "Magnificent Seven" tech stocks fractured, with Apple and Tesla experiencing losses.

Sector performance was broad-based, with all 11 MSCI AC World sectors recording positive returns. Unlike 2023, Information Technology (+17.2%)[9] wasn't the sole leader. Other top performers included Communication Services (16.5%)[10], Financials (14.3%)[11], Energy (+14.4%)[12], and Industrials (+14.1%)[13]. This mix reflects AI enthusiasm, strong financial guidance, and solid economic data. The diversified gains demonstrated that the Q1 rally was driven by a more varied set of influences beyond just AI enthusiasm.

Turning to the laggards, Real Estate (+3.6%)[14] continues to be weighed down by concerns about the health of the commercial real estate market. Defensive sectors like Consumer Staples (+7.4%)[15] and Utilities (+6.1%)[16] faced headwinds from stronger-than-expected economic growth and higher rates also reduced investors' appetites for these higher dividend-yielding sectors, resulting in sluggish returns year-to-date after being some of the best relative outperformers in 2022.

1 Measured by the S&P 500 in AUD & Measured by the NASDAQ Composite Index in AUD
2 Measured by the German DAX 40 in AUD
3 Measured by the Nikkei 225 in AUD
4 Measured by the French CAC in AUD
5 Measured by the MSCI EM (Emerging Markets) in AUD
6 Measured by the MSCI AC World Small Cap in AUD
7 Measured by the MSCI World Index Growth in AUD
8 Measured by the MSCI World Index Value in AUD
9 Measured by the MSCI AC World Index Information Technology in AUD
10 Measured by the MSCI AC World Index Communication Services in AUD
11 Measured by the MSCI AC World Index Financials in AUD
12 Measured by the MSCI AC World Index Energy in AUD
13 Measured by the MSCI AC World Index Industrials in AUD
14 Measured by the MSCI AC World Index Real Estate in AUD
15 Measured by the MSCI AC World Index Consumer Staples in AUD
16 Measured by the MSCI AC World Index Utilities in AUD

Real estate

As central bankers ramped up cash-rate targets from 2022 onwards, assets whose most appealing characteristics were tied to their income production, suffered. With ZIRP ('zero interest rate policies') becoming dominant into the pandemic, those investors with an income focus were forced out along the risk spectrum. However, when interest rates increased, much more attractive levels of income were available at significantly lower risk levels. As such, the valuation of Real Estate assets suffered. With the tightening cycle now likely at or near its peak, the market is becoming increasingly rational. Such conditions saw Australian Real Estate Investment Trusts (A-REITS) gain 16.5%[1] during the final quarter of 2023. This was followed up with a similarly strong outcome in the March quarter, with a gain of 16.2%.

The strength of the domestic market was not entirely reflected in global peers, with Global Real Estate Investment Trusts (G-REITS) delivering a more sedate 3.2%[2]. Indeed, the transition of monetary policy has driven a reasonable degree of dispersion across geographies and sectors, which has continued through the first quarter of 2024. Japan was the outstanding leader for G-REITS, gaining an impressive 11.4%[3], as the local economy moves into arguably its strongest position in decades. Meanwhile, Hong Kong continues to disappoint as negativity surrounding China's property market bleeds across into sentiment, whilst the erosion of democratic norms drives an exodus from the rapidly declining economic hub.

When we drill into the outcomes of individual sectors, we continue to observe a meaningful degree of differing fortunes. Office continues to lag, with only 0.3%[4] of returns for the quarter. That it was positive was meaningful. The sector has seen negative returns of -1.0% annualised for the past 9 years. On the up-side, Hotels & Resorts continue to move from strength-to-strength, gaining 11.9%[5] for the period, rounding out an impressive 12-month return of 33.5%.

Alternatives

Echoing the trend in traditional markets, Alternative investments delivered positive returns in Q1 2024. Unlisted assets generally lagged the public market rally, though pockets of opportunity emerged. Infrastructure continued to be a strong performer, attracting investors seeking its reliable, inflation-protected cash flow.

Real estate markets globally experienced subdued transaction volumes, with cap rates continuing to compress. Income alternatives, on the other hand, thrived in Q1. Both leveraged loans and high-yield bonds benefitted from positive earnings reports, lower-than-anticipated defaults, and tighter credit spreads. Private debt, particularly first-lien unlevered debt, is expected to underperform newer vintages but offers portfolio stability.

Overall, alternative asset managers are adapting to the evolving market environment by focusing on income generation, liquidity, and strategic allocation across sectors. While uncertainty surrounding inflation and interest rates remains, the potential for a more accommodative monetary policy and a positive shift in investor sentiment suggest an improving outlook for alternative assets.

1 As measured by S&P ASX 300 A-REITS in AUD
2 As measured by the FTSE EPRA Nareit Developed in AUD
3 As measured by the FTSE EPRA Nareit Japan Index
4 As measured by the MSCI World / Office REITs index
5 As measured by the MSCI World / Hotels & Resorts REITs index

Fixed income

2023 ended strongly for Fixed Income assets. Indeed, over the months of November and December, with an apparent chorus of dovish messaging coming from the likes of the European Central Bank, the U.S. Federal Reserve, the Bank of England and our Reserve Bank; we saw bond investors lean into expectations of imminent rate cuts, driving bond prices higher. As we began 2024, some 7 rate cuts were priced into the U.S. Treasury yield curve for the year. Ultimately this backdrop was driven by the substantial progress that had been made in taming what had become threatening inflationary pressures. At the time of writing, the level of cuts now priced into U.S. bond yields is down to just two. The softening of expectations for a dovish tilt, led to a mildly negative return over the quarter for the Bloomberg Global Aggregate benchmark (hedged to AUD) of -0.31%[1]. This represents a negative capital return, with approximately 0.89% of yield making up the difference. Whilst the overarching theme of 'higher for longer' was also applicable to our domestic market, the change in expectations was far subtler, leading the return of local bonds to be a relatively robust 1.0%[2]. Though again, this was almost entirely from coupons.

What appears to have been the main driver of change over the quarter is the simple fact that inflation is not coming down as fast as it was. As we get closer to target, more sticky components of CPI are remaining stubbornly high. In the Reserve Bank Board's statement following their March meeting, they imply this very concern in saying "data [is] consistent with continuing excess demand in the economy and strong domestic cost pressures, both for labour and non-labour inputs". Fed Chair Jerome Powell made a similar point when he noted in early July "We do not expect that it will be appropriate to lower our policy rate until we have greater confidence that inflation is moving sustainably down toward 2 percent".

It is ultimately these concerns that will continue to dominate the sovereign curves for most developed countries through to the end of 2024. The strength of corporates and how they are ultimately able to adjust to the higher rate environment, drives outcomes in credit. In recent times, credit has proven to be relatively attractive as companies were able to pay attractive levels of income and levels of default were historically low. That theme continues to remain, however with some sectors facing growing margin pressures, focus continues to be on default rates which have been building momentum recently. Over this past quarter however, outcomes have been relatively robust with Australian credit returning a steady 1.37%[3] for the quarter. Global corporates were off by 0.10%[4], dragged down by yield curve adjustments. Meanwhile, Global high yield generated a respectable 2.30%[5].

Australian Cash rate

The Reserve Bank of Australia (RBA) decided to keep interest rates on hold at 4.35% throughout the quarter while they closely monitored the economy. Despite earlier talk of imminent rate cuts, the timing seems to be increasingly delayed. This was evident in the minutes from the RBA's March meeting, where the Board struck a more neutral tone but did not provide forward guidance on when they expect to cut rates.

With inflation still exceeding the target range, particularly in the services sector, the RBA appears cautious about cutting rates too soon. They likely await further signs of inflation falling towards their target before acting. Market expectations for the first rate cut have shifted to the latter part of 2024. This delay presents a challenge for the RBA as they navigate achieving a "soft landing" for the economy, at the same time as bringing inflation back down to their target range of 2-3%.

Australian dollar

The Australian dollar (AUD) experienced a period of fluctuation throughout the first quarter of 2024, ranging between 64 and 69 US cents[6] throughout the period. This mirrored the broader market volatility seen across exchange rates for Australia's key trading partners.

The main driver behind the AUD's performance against the USD was uncertainty surrounding potential interest rate cuts by the US Federal Reserve. A strong start for the AUD, gaining 2.5% against the USD early in the quarter, reversed as positive US economic data hinted at a delay in these cuts. As a result, the AUD settled slightly above its starting point at around 0.65 USD.

Elsewhere, traditional 'safe haven' currencies such as the Yen and the Swiss Franc declined against AUD over the March quarter. Overall, the AUD avoided any dramatic movements and ended the quarter close to its starting position against most currencies, despite some volatility.

1 As measured by Bloomberg Global Aggregate Index in AUD hedged
2 As measured by Bloomberg AusBond Composite (0+Y) in AUD
3 As measured by Bloomberg AusBond Credit (0+Y) in AUD
4 As measured by ICE BofA Global Corporate index in AUD unhedged
5 As measured by Bloomberg Global High Yield index in AUD unhedged
6 Source: FactSet

Global economic overview

Delicate Balancing Act

Progressing through the first few months of 2024, it is clear that we are living through a particularly interesting moment in the long history of capital markets. The present blend of increased interest rates, strong labour markets, buoyant economies, and healthy labour markets; is unusual, to say the least. Indeed, only a year ago, most economists expected that the developed world would have entered a recession by now. Today, the probability of an economic downturn is increasingly being downgraded by investors. Should this continue, we may be facing an environment akin to that during the mid-1990s.

Why the Mid-1990s Offer a Compelling Comparison for Today's Market Landscape

The adage "history doesn't repeat, but it often rhymes" rings particularly true when examining the current economic climate. Whilst the past isn't a crystal ball, drawing parallels with historical periods can offer valuable insights into the present. Reflecting on this past quarter, the mid-1990s exhibit a striking resemblance to today's market landscape, offering reasons for both optimism and measured caution.

In our previous Quarterly Market Update, we explored the similarities between today's economic conditions and that of the 'roaring 1920s'. However, the 1920s expansion ultimately ended with a resounding crash, plunging the global economy into the Great Depression. While a recession in 2024 isn't entirely out of the question, the possibility of a soft landing – a scenario where economic growth moderates without a downturn – is increasingly likely. Relating the current market to the mid-1990s, a period that witnessed a successful and rare soft landing, becomes an increasingly worthwhile exercise.

Rewinding the VHS tape almost 30 years; the first Toy Story had just graced the silver screen, Coolio's "Gangsta's Paradise" dominated the music charts, and the ASX All Ordinaries was trading just above 2,000 (in stark contrast to today's level - comfortably above 8,000).

The mid-1990s were characterised by the beginning of a historic multi-year rally in stocks, fuelled by a crucial and successful pivot by the US Federal Reserve (Fed) and other major central banks. After a series of rate hikes to combat an overheating economy, the Fed and later, the Reserve Bank of Australia (RBA), cut rates, delivering a textbook example of a 'soft landing'.

Fast-forward to present day, and most major central banks expect that they are done hiking rates, with focus moving to aspirations of matching the deft policy shift of the 90s. Increasingly the question they are asking themselves, is 'when will it be appropriate to cut rates', whilst at the same time, balancing the competing goals of achieving an economic soft landing, and avoiding a re-acceleration of inflation.

In examining the similarities and differences between the macroeconomic backdrop of the mid-1990s and the present, we can glean valuable insights and identify potential opportunities.

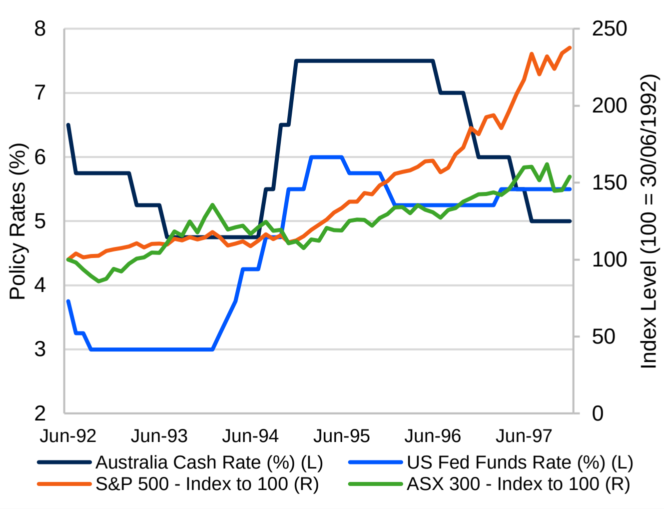
Below we consider 3 broad themes that were as relevant 30-years ago, as they are today: a Central bank balancing act, labour market resilience and narrow market leadership.

A Tale of Two Eras

Central Banks Orchestrate a Delicate Balancing Act

- **Mid-1990s:** Between February 1994 and February 1995, Alan Greenspan led the Fed to almost double the fed funds rate in just seven meetings, from 3.0% through to 6.0%. Whilst investment performance was subdued and economic growth slowed for a couple of quarters, a recession was successfully avoided, and inflation steadily adjusted to near central bank targets. Subsequently, most central banks implemented a policy shift in 1995, with the Fed cutting rates three times. After its July 1995 decision, the FOMC wrote that *"as a result of the monetary tightening initiated in early 1994, inflationary pressures have receded enough to accommodate a modest adjustment in monetary conditions."* The Reserve Bank of Australia followed a similar playbook to their US counterparts, having raised rates several times in 1994, before cutting in 1996 to stimulate the economy. In both countries, this ultimately paved the way for a soft landing.

Figure 1. Cash rates and equity markets



Source: FactSet, Perpetual Private.

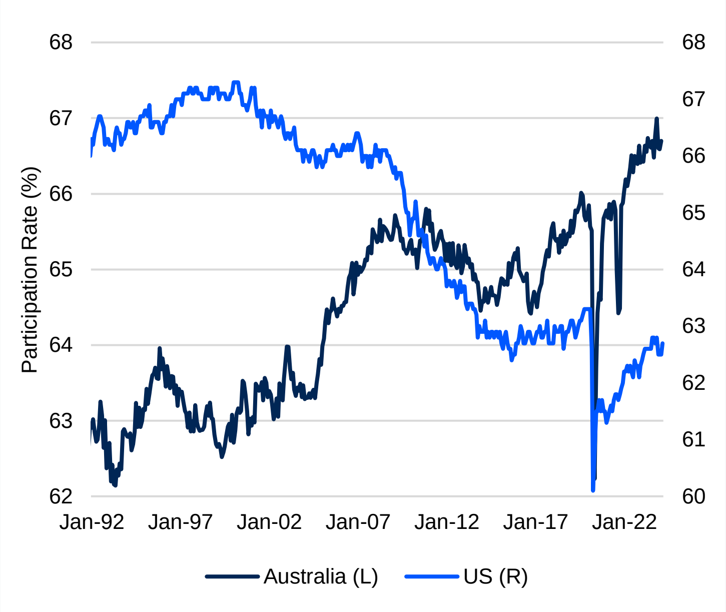
- **Today:** The Fed and RBA, along with most other globally important central banks, raised rates aggressively throughout 2022 and 2023, aiming to cool an overheating economy. Mirroring the mid-1990s, central banks have now shifted their stance from contemplating further tightening to potentially easing monetary policy later this year, in order to support financial conditions, thus bolstering the likelihood of a soft landing scenario. Historically, tight monetary policy conditions have often been precursors to recessions. However, with inflation showing signs of cooling, rate cuts now being on the cards, and the labour market proving resilient, the prospects for more positive outcome are encouraging.

Labour Market Boom and Productivity Surge

Figure 2. Labour Productivity – Then vs Now

Source: FactSet, US Bureau of Labor Statistics.

Figure 3. Participation Rate – Then vs Now

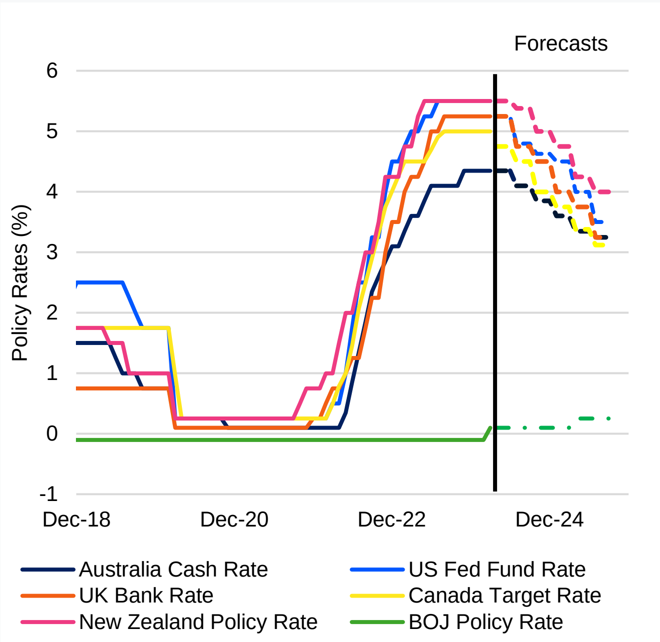


Source: FactSet, Perpetual Private.

- **Mid-1990s:** The mid-1990s witnessed a robust labour market fuelled by a multi-decade rise in female workforce participation. According to the US Bureau of Labor Statistics (BLS), the labour force participation rate reached its post-war peak in 2000. This trend coincided with a significant surge in productivity growth, driven by two key factors: increased globalisation and the widespread adoption of computers and the internet. Notably, 1996 marked a pivotal year when email usage surpassed traditional 'snail' mail in the US.

- **Today:** Australia and the US are currently witnessing a similar labour market boom, this time driven by a surge in immigration. This trend, though potentially short-lived, creates a favourable scenario for economic growth in the short-to-medium term. In addition, the potential impact of Artificial Intelligence (AI) on productivity offers another interesting parallel. Whilst we haven't witnessed a dramatic leap yet, the early signs of rising productivity and lower real labour costs per unit of output are compelling. AI holds the promise of a long-lasting boost, similar to how computers and the internet revolutionised productivity in the late 1990s. Although AI may not be a magic bullet that instantly transforms the economy overnight, its broader adoption throughout the latter half of this decade will likely lead to enhanced productivity. The big questions remaining; when? and to what degree?

Figure 4. Central Bank Policy

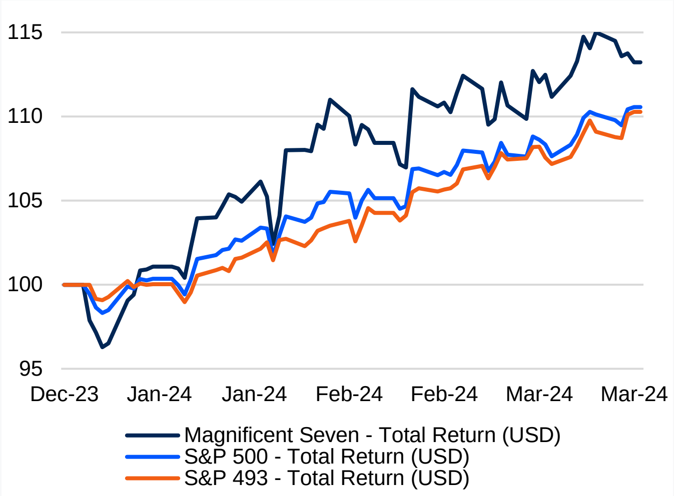


Source: FactSet, Perpetual Private. Median Economist Forecast.

Narrow Market Leadership: A Cause for Measured Optimism

- **Mid-1990s:** Easy financial conditions and a successful central bank pivot from rate hikes to cuts without triggering a recession, provided the fuel for the strongest bull market in history. However, this cocktail of macroeconomic trends also fostered speculation that culminated in the creation of and subsequent collapse of the dot-com bubble in 2000. Four mega-cap stocks, dubbed the "Four Horsemen" (Microsoft, Intel, Cisco, and Dell), spearheaded the charge, which was heavily concentrated in internet-related stocks, with many unprofitable firms experiencing extraordinary gains. The party abruptly ended when central banks were forced to raise rates again at the turn of the millennium to combat inflation, ultimately resulting in the "popping" of the dot-com bubble and subsequent market fall-out.

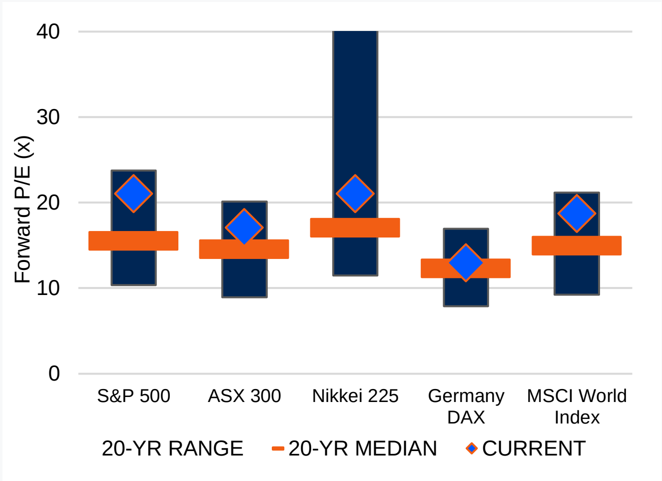
Figure 5. Magnificent Seven vs the Rest - Growth of $100



Source: FactSet, Perpetual Private. Returns are net of fees and in USD.

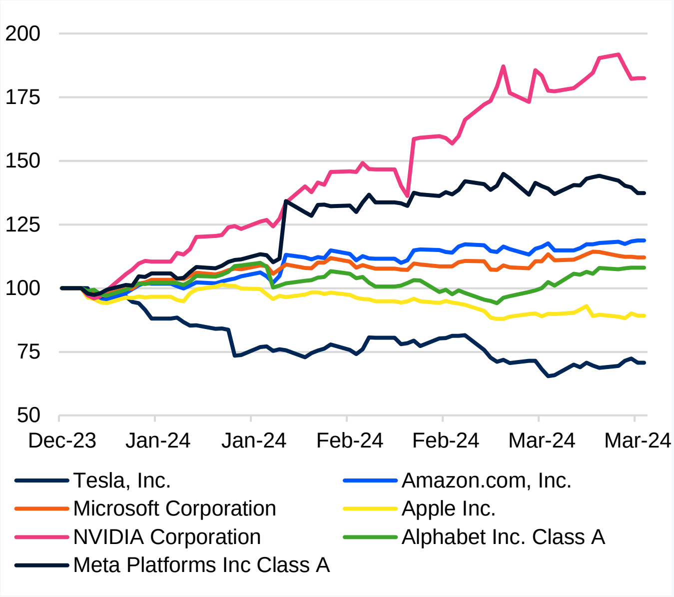
- **Today:** As has been widely discussed, a significant portion of the gains in 2023 can be attributed to a select group of stocks dubbed the "Magnificent Seven" (NVIDIA, Microsoft, Alphabet, Amazon, Meta, Apple, Tesla), all considered leaders in the field of AI. These companies were largely responsible for driving global equity market gains last year and currently trade at an elevated forward price-to-earnings (P/E) ratio of 31. It's important to note that, while elevated, this P/E ratio is significantly lower than the exorbitant valuations of the Four Horsemen in 1999, which averaged a P/E of 85! Additionally, the outsized gains of these mega-cap tech stocks have been supported by robust earnings performance in both absolute and relative terms compared to the broader market. While the market has seen strong gains in recent months, the risk of a broad market bubble similar to the dot-com bubble, appears less likely. Unlike the mid-1990s, the rally in the first quarter of 2024 has begun to broaden, encompassing small-to-mid-sized companies. International markets and non-AI sectors have also performed well, and value stocks have even outperformed growth stocks during the month of March. Nevertheless, investors should remain aware of potential risks associated with narrow market leadership.

Figure 6. Global Valuations of Major Equity Indices



Source: FactSet, Perpetual Private.

Figure 7. Magnificent Seven Dispersion – Growth of $100



Source: FactSet, Perpetual Private. Returns are net of fees and in USD.

As is plain to see, there are some reasonably compelling implications that can be drawn from the mid-1990s and applied today. It is notable that whilst the 90s delivered strong returns for investors, it wasn't all plain sailing, and there were key areas to avoid, albeit with strong positive opportunities abounds. If we draw our attention more keenly to the present time, we have identified four key areas that we feel will continue to dominate market sentiment over the coming months.

Key Takeaways from the Quarter

Market Rally Defies Expectations in Face of Elevated Risks

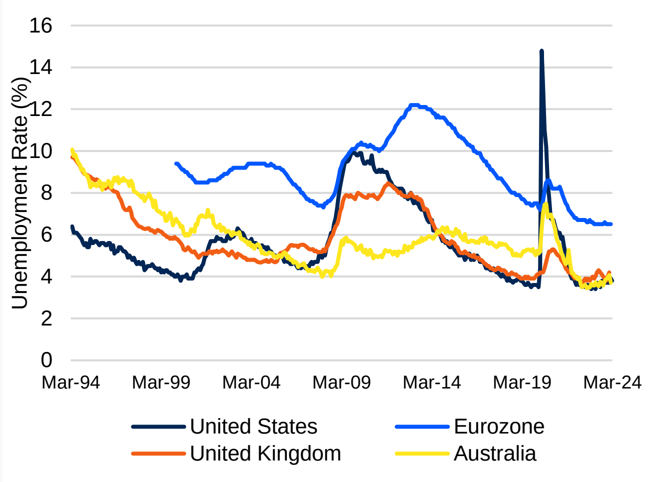
Investment markets have defied gravity this past quarter, scaling new heights globally in a scenario that seems to contradict the headlines. Geopolitical tensions, inflationary whispers, and central bank jitters, were all supposed to be the market's undoing. Yet, here we are, witnessing a broad-based rally that extends far beyond the initial surge in US tech stocks. Whilst we appreciate the buoyant returns that this environment has provided, there is a sense that positive sentiment has lent itself to an optimistic bias across markets. We note that should there be a series of negative surprises across the corporate and economic landscape, investors glasses may become a little less 'rose tinted'.

Geopolitics

Despite a backdrop simmering with geopolitical tensions – the ongoing war in Ukraine, the intractable conflict in Gaza, a relentless cycle of national elections (not least the crucial US election later this year) and simmering tensions with China – markets have continued their remarkable climb. This paradox of market resilience can be attributed to several factors. Perhaps most importantly, the potential for major disruptions from these geopolitical flashpoints hasn't materialised (yet). While these issues continue to simmer, they haven't escalated to a level that significantly disrupts global trade or financial flows. Additionally, institutions like the United Nations, the European Union, and NATO, despite their limitations, appear to be functioning as a buffer against widespread conflict. Beneath the surface tensions, a modicum of rationality seems to be prevailing in international relations.

Labour Markets

Figure 8. Unemployment Rates



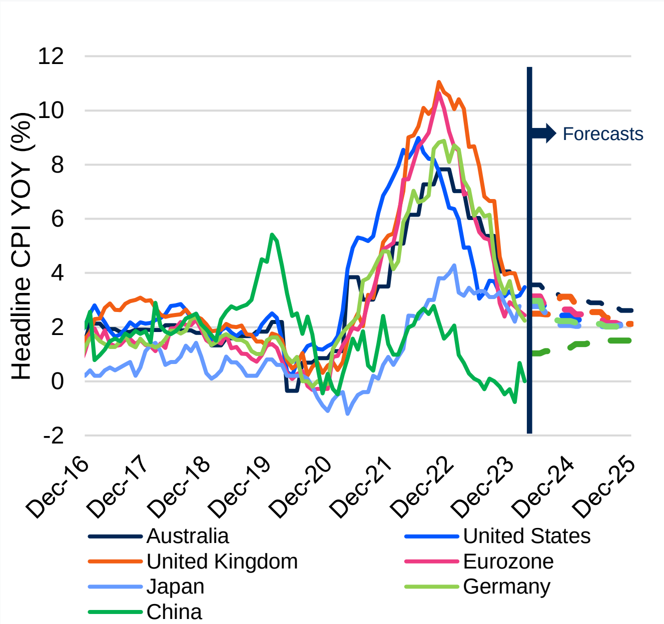
Source: FactSet, Perpetual Private.

Labour markets have remained remarkably resilient despite concerns that rising interest rates would lead to higher unemployment. Unemployment in Australia remains low and hasn't budged significantly. Additionally, the participation rate has increased. However, there are signs that the previously red-hot labour market might be tempering. While wage pressures remain a concern for central banks, with recent reports indicating a 14-year high in wage growth, there's also evidence that the labour market is loosening. The number of job vacancies has been falling for some time, indicating a slight softening in demand for labour. This trend could help alleviate pressure on wages in the coming months.

Central Banks and Inflation

Whilst inflation in most developed countries remains above respective central bank targets, it is broadly trending in the right direction. In Australia, monthly CPI inflation has come in under expectations for five months in a row, printing at 3.4% YoY in February. This positive development in inflation has seen central banks shift their stances. Gone are the days of aggressive rate hike pronouncements. Instead, most central banks have adopted a more neutral bias, hinting at rate cuts later this year.

Figure 9. Consumer Price Inflation



Source: FactSet, Perpetual Private.

However, the situation isn't uniform. The Bank of England and the European Central Bank face a tougher fight due to persistent inflation and weaker growth. The RBA finds itself in a more challenging position. Persistently high inflation, strong wage growth pressures, weak productivity growth, a tight labour market, and the impact of the revamped Stage three tax cuts, are likely to keep the RBA cash rate at its current level of 4.35% for the remainder of this year. The Fed is taking a wait-and-see approach given the US economy's resilience.

Conclusion

Although the past may rhyme with the present, it never repeats itself exactly. Investors should leverage the insights gleaned from history but remember that future outcomes can deviate. Just like Buzz Lightyear's famous quote from Toy Story, "To infinity and beyond!" embodies the boundless potential for market growth, it also serves as a cautionary reminder against unbridled optimism.

As we begin the second quarter, we are undoubtedly in a favourable environment, setting us up nicely for a possible repeat of the mid-1990s soft landing. However, the strong rally of the last six months has left equity markets at previously historically expensive valuations, and investor sentiment is very bullish - potentially even complacent. This means that even though the outlook is positive, it's essential we continue to monitor the macro and micro-economic horizons for risks. At current elevated valuations and with sentiment bullish, the market is vulnerable to a negative surprise.

Specifically, while it's true that global economic growth has remained resilient in the face of higher rates, some data is pointing to a possible loss of momentum. Inflation is still retreating, but the pace of that decline has slowed quite meaningfully, raising concerns that the 'last mile' of bringing inflation back down to within central bank's target range, may take some time yet. Meanwhile, other anecdotal indicators of inflation have hinted at a rebound in prices. If inflation bounces back, it will reduce the number of rate cuts expected by the RBA, the Fed and other central banks in 2024.

To that point, markets expect the Fed to cut rates two-to-three times in 2024, beginning in June, and for the RBA to begin easing in August. This assumption was central to the first quarter rally in markets. However, any deviation from this timeline, with central banks cutting less aggressively or later than anticipated, could lead to disappointment and a potential correction in stock and bond prices.

Investor enthusiasm for artificial intelligence (AI) remains a key driver of the bull market, bolstered by strong earnings reports from companies like Nvidia. The hope is that AI integration will trigger a boost to productivity and profits across the entire market, not just tech companies. However, if AI's impact remains largely confined to the technology sector, it could dampen investor sentiment.

Bottom line, the rally seen over the last five months is supported by positive fundamentals and as mentioned, the mid-1990s offer a compelling historical parallel to today's investment environment. It remains to be seen whether the soft landing scenario will play out this time - even the successful soft landing of the 1990s wasn't without its challenges. The current healthy market environment shouldn't obscure the underlying risks. We are encouraged by market performance, but we must acknowledge the vulnerability of markets to negative news.

As the past few years have shown, a well-defined, long-term investment strategy with broad diversification can weather market volatility and unforeseen events. More than ever, navigating the current market requires a keen eye for the potential risks that could disrupt this delicate balance, whilst still being prepared make decisive moves when the time is right.

Australian Equities

Over the quarter, the rally in Australian shares continued and expanded on the strong gains experienced over the prior nine months. Indeed, following the 8.4% return (as measured by the S&P ASX 300 index) over the prior quarter, 5.4% feels relatively tepid. It should be noted however, the 14.4% gains over the past year, are meaningfully higher than long term annual averages for the index. As such, it is important to enjoy these returns within context. This buoyancy ultimately reflects optimism about economies, domestic and local, and monetary policy (i.e. that interest rates will soon fall). This building force of positive sentiment has now begun to 'lift all boats', with smaller companies (as measured by the S&P ASX Small Ordinaries) growing by 7.6%, aided by increasing levels of M&A (another sign of growing confidence in the market).

As has been the case since the abrupt change in interest rate policies in 2022, different companies and different sectors experienced meaningfully different outcomes. Continuing to be weighed by reduced demand (particularly from China) whilst being squeezed on labour costs, the Materials sector gave up 6.3% over the quarter. Also trailing, albeit delivering positive returns were Communication Services and Consumer Staples (returning 1.1% and 2.1% respectively), both of which dragged due to their exposure to highly rated defensive stocks. At the other end of the pack, Information Technology returned 23.6% with enthusiasm for the sector, combining with impressive earnings outcomes, to drive an upwards valuation re-rating. Unfortunately, the sector is relatively small within Australian markets, accounting for only 3.0% of market capitalisation versus Materials, for instance, at 22.4%. Fortunately, Real Estate, Financials and Consumer Discretionary (43.9% of the market) enjoyed robust double-digit gains over the quarter, delivering 16.2%, 12.1% and 13.4% respectively.

Stylistically, the period saw Growth assets comfortably outstrip Value, 7.7% to 3.0%. However, this is not a surprise given the broader context of AI-inspired optimism and some outstanding outcomes for a number of more growth orientated names.

Figure 10: Australian shares

Source: FactSet, Perpetual Private

Australian Equities Outlook

After a very strong finish to the 2023 calendar year, where we saw the Australian Shares up 8.4% for the quarter to end December and finishing only around 100 points shy of their August 2021 record high, we embarked on the new year feeling somewhat cautious about share price valuations more broadly and the outlook for future earnings. Markets, we felt, were optimistically pricing in several rate cuts for the year ahead, despite stubborn inflation sitting ~2% above the RBA's target range, strong net immigration and tight labour markets with persistent wage inflation. We felt the pressure on corporate earnings from higher interest rates and a slowing economy (and potentially weaker consumer spending) had further to play out, whilst heightened economic and geopolitical uncertainty would also pave the way for sustained volatility in equity markets over the shorter term. Against this backdrop, entering the quarter the portfolio was positioned towards managers with a stronger regard for valuations and balance sheet strength. In addition, managers who were focused on investing in quality (ideally industry-leading) companies with the pricing power to pass on higher costs, thereby preserving their profit margins. At the sector level, key overweights were Tech, Healthcare and Consumer Discretionary stocks, with our managers seeing opportunities in select names where a high degree of pessimism was already baked into the share price. Conversely, we were under-weight other cyclical sectors, these being Financials, Materials, REITs and Energy names.

The main event for this quarter was the February reporting season, and generally speaking the results were not as bad as analysts had been forecasting. This was largely driven by more resilient consumer demand than had been anticipated. This resulted in strong share price rallies from the more cyclical names within Tech (+23.6%) and Consumer Discretionary (+13.4%), and our portfolio benefited from an overweight to both sectors. Artificial Intelligence remains a thematic tailwind, with companies focused on how this can be integrated into their business models to drive operational and cost efficiencies. We are also seeing an uplift in corporate activity (mergers and acquisitions), which we expect is largely being driven by the perception that rates have stabilised with further rate cuts to come in the short term. A key example of this is the electronic design automation software company, Altium. The stock was up 40% for the quarter, having received a successful takeover offer from Japan's Renesas Electronics Corporation in February at a 33% premium to the prevailing share price. We were also mindful of the supply-demand shift we've been observing within the Resources (Materials) sector, with an oversupply and contraction of demand contributing to lower commodity prices. At the same time, the sector was also battling ongoing cost pressures, for labour, which has squeezed their margins. These headwinds have continued for the Materials sector, being the only negative sector (-6.3%) for the period. Our underweight exposure to this sector has been a considerable driver of outperformance.

Looking ahead, on one hand we remain cautious on the likely path of interest rates, with tight labour markets, strong net immigration and sticky services-based inflation potentially driving central banks to delay cutting rates – with any delays here expected to put pressure on equity markets. The tightness in labour markets is a key signal that we are monitoring closely and one that we expect should be a key influence on the path of inflation, and subsequently interest rates. Of note, the unemployment rate in Australia unexpectedly fell from 4.1% to 3.7% near the end of the quarter despite a slowing economy, which sparks some concerns that rates may be kept on hold for longer than anticipated. Against this backdrop we would typically favour managers with a 'Value' style bias. While on the other hand, we are mindful that broad economic data is signalling rates may have peaked and this stability, coupled with a more resilient consumer, the cooling of inflation and the potential for rate cuts in the near term, should benefit those managers with a 'Growth' style bias. Against this dichotomy, we currently maintain a relatively style neutral approach albeit with a slight bias to SMID (small-to-medium) sized companies, as this is where our active managers are seeing stronger opportunities. Greater market inefficiencies at this end of the market cap spectrum (i.e. less analyst coverage of these stocks) coupled with the sustained volatility in equity markets, we believe should bode well for active managers in this space looking to deploy capital to attractive companies from a relative valuation perspective.

International Equities

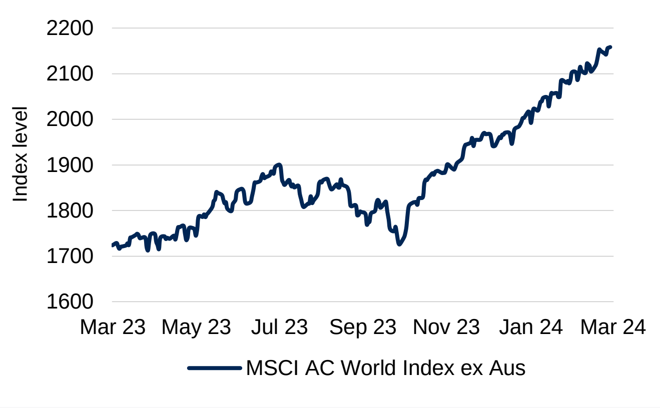
International shares, like their domestic counterparts, enjoyed a strong first quarter to the year. As has been the case over multiple periods. International equities outperformed locally listed companies by a meaningful margin (13.2% vs 5.4% in Australian dollar (AUD) terms). The currency impact over the 3 months was meaningful, with our most important exchange rate (AUD vs U.S. dollar) declining by 4.4% over the quarter.

Particularly encouraging over the period was the regional broadening of contributors to international equities performance. Of the major markets we follow, only the UK (FTSE 100 index) and Hong Kong (Hang Seng index) failed to generate double-digit returns over the quarter; still delivering 7.8% and 1.7% respectively. Factoring out currency effects, these results are less impressive but still consistent with the theme of broadening support for global share markets.

Sector performance was broad-based, with all 11 MSCI AC World sectors recording positive returns. Unlike 2023, Information Technology (+17.2%) wasn't the sole leader. Other top performers included Communication Services (16.5%), Financials (14.3%), Energy (+14.4%), and Industrials (+14.1%). This mix reflects AI enthusiasm, strong financial guidance, and solid economic data. The diversified gains demonstrated that the Q1 rally was driven by a more varied set of influences beyond just AI enthusiasm. Turning to the laggards, Real Estate (+3.6%) continues to be weighed down by concerns about the health of the commercial real estate market. Defensive sectors like Consumer Staples (+7.4%) and Utilities (+6.1%) faced headwinds from stronger-than-expected economic growth and higher rates also reduced investors' appetites for these higher dividend-yielding sectors, resulting in sluggish returns year-to-date after being some of the best relative outperformers in 2022.

Of similar interest is the observation that the growing buoyancy of equity investor behaviour, is increasingly being enjoyed by smaller companies. Although they are currently lagging their larger peers (8.7% vs 13.2% in AUD terms over the quarter), smaller companies appear to be building some momentum, having been out of favour for a period.

Figure 11: International shares (local currency terms)



Source: FactSet, Perpetual Private

International Equities Outlook

With the hype around the 'Magnificent 7' and Artificial Intelligence, combined with the sanguine economic environment it would have been brave to expect anything other than a positive outcome for the first quarter of 2024. With AI having application across multiple sectors and disciplines, we had been spending time thinking about how AI could manifest within corporates, and what this would mean for both near term capital expenditure (capex)/operational expenditure (opex) as well as future cost savings/efficiencies. In speaking with our managers, it became clear that the capex/opex required to implement AI solutions on a large scale would be very capital intensive and not likely to bear much fruit for a couple of financial years. As such, in the early stages of AI adoption, we expect larger companies to be better positioned to finance this capex/opex, while smaller companies may hold off in the near term, seeking greater certainty around the efficiency and productivity benefits that AI promises. It will be interesting to see how this theme plays out in coming periods.

Stepping away from AI, and focusing on the health of corporates more broadly, with interest rates stabilising we had been focused on developing a clearer picture of the health of corporates as we moved into 2024. Margins remain elevated in the post COVID-19 world, as many firms have discovered customers are 'stickier' than they had expected. While margins remain robust, there are other factors which could impact corporate financial performance such as refinancing costs - as older debt is refinanced at materially higher interest rates - or variability in input costs. As such there is room for some margin contraction and/or profit downgrades. However, pleasingly, we have seen some positive earnings revisions mainly within Communications, Technology, and Consumer Discretionary sectors. Those sectors which have seen materially negative earnings revisions have been in the more cyclical sectors of Materials and Energy. At this stage, the macro-economic environment is supportive of further growth, and so we're optimistic that this momentum can be maintained through the remainder of the year.

Finally, many would be aware that the equity market is 'narrow' presently, with a large proportion of performance being driven by a small group of stocks ('Magnificent 7'), who are also trading on reasonably lofty valuation multiples. The Top 10 and Top 20 names within the benchmark currently represent a similar weight to the same groups in the lead up to TMT Bubble of the late 1990's. This time around we see one notable difference, being the profitability of mega caps being materially higher, and therefore (at least to some extent) able to justify higher valuations. That said, not all of the largest companies are created equally, and we had hoped we'd either see a broadening of the rally which started in early Q4 2023, or a change in market leadership. Pleasingly, both have begun to play out, with Tesla and Apple delivering negative returns (in local currency) YTD, with the former, along with several other companies (e.g. JP Morgan) falling out of the MSCI AC World Index top 10 names. This shift in market dynamic has the potential to continue for some time, and so we watch with interest.

Real Estate

As an asset class that is intimately tied with changes to interest rates, Real Estate has had a challenging and volatile couple of years. Indeed, the final quarter of 2023 we saw Australian Real Estate Investment Trusts (A-REITs) deliver 16.5% gains whilst their global peers (G-REITS) delivered an uplift of 9.1% on an unhedged basis.

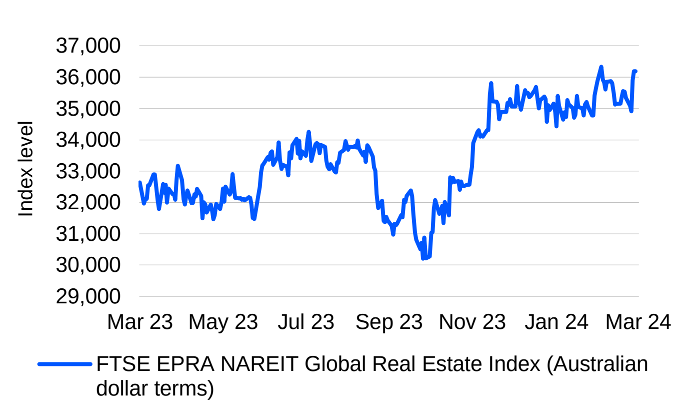
With interest rate expectations diffusing across regions throughout the March 2024 quarter, the outcomes for Real Estate were varied across regions and sector. In Japan and Australia, where monetary policy has remained more anchored, assets enjoyed gains of 11.4% and 16.2% respectively, leading the global market which returned 3.2%. On the negative side of the ledger, Eurozone assets gave up 0.4% as expectations of interest rate cuts were pushed further into the future. As an outlier, and primarily tied to its diminishing status as a global hub, Hong Kong declined by 10.1%.

From a sectoral point of view, Hotels and Resorts continued to impress following up 16.4% in the December quarter with an 11.8% increase during the March quarter. Having been acutely impacted by the pandemic, the sector is now the best performer in the four years since the WHO declared COVID-19 a pandemic, providing a 17.0% return per annum. Meanwhile offices, arguably impacted by the pandemic on a longer-term basis, continues to trail with only 0.3% over the quarter and -4.5% per annum over the same four years.

Figure 12: Australian Real Estate Investment Trusts (A-REITs)

Source: FactSet, Perpetual Private

Figure 13: Global Real Estate Investment Trusts (G-REITs)



Source: FactSet, Perpetual Private

Real Estate Outlook

With 2023 ending on a strong positive note, we expected sector and regional dispersion to remain high. Office, the foremost casualty of the covid-era has yet to stabilise, while the beneficiaries; industrial and data centres continue to grow albeit at a slower rate than the highs experienced last year. China remains mired in a property slowdown as residential development is stalled by corporate failures and Hong Kong suffers from its close association. In contrast, US REITs, having adjusted asset values downward, has seen the discount to NAV narrow. Artificial Intelligence, the cause of much market optimism in 2023 is already impacting data centres but for now, the longer-term effects are uncertain. Housing shortages, prevalent in the US and Australia, resulted in support for residential REITs over recent years and widespread development in the US particularly among "Sunbelt" regions in the mid-west and parts of the South.

During the quarter, the Bank of Japan took an initial step to unwind its yield curve control. The action was modest and appears to have buoyed investors in the region as it led returns in the index among key regions.

Equinix, a US-based, multi-national data centre developer and operator, and second largest stock in the index, closed the quarter under a cloud. A short-seller report disputing management and accounting practices has triggered an investigation by a Californian Attorney General's Office and internal Board and Audit Committee reviews. As a result, the stock has lagged the broader market and is likely to remain under pressure in the near term. This is unlikely to dent global interest in the sector itself as evident in the performance of Goodman Group in Australia returning 33% and driving the domestic index higher. The company continues to evolve from its pure industrial heritage to expand its data centre capacity, a move that has been well received by investors.

The dispersion we expected has continued, however the pace of the market response to the changing rate environment has been a surprise. In particular, the degree of price rises experienced in the domestic sector. It is notable that the price response has occurred while rental growth rates have been slowing and transaction activity remains muted. There has been further evidence of assets being marked down over the quarter and so, looking forward, valuations look more appropriate and growth rates more akin to normal conditions. This suggests a moderation in overall real estate returns although any cut in rates later in the year may trigger short term bumps. As the year progresses, we will look for improving conditions in China and some catch up in UK and European pricing. At a sector level, themes appear well entrenched but we expect some moderation, whether it be an easing of pressure on office or a continued slowdown in industrial growth rates and a slowdown of residential supply.

.

Alternatives

Growth alternatives

Traditional asset classes continued to rally through Q1 2024, while unlisted asset classes continued to exhibit more modest movements. In local currency terms contributors were Private Equity, Infrastructure, Other Growth Alternatives, Hedge Funds. Opportunistic Property detracted over the quarter. The falling AUD also contributed to returns.

Demand for Infrastructure has begun to soften, evidenced by a number of transactions seeing price guides revised downwards, while investment managers report fund raising for long duration interest rate sensitive assets has been weaker. That said, 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. In the current sanguine macroeconomic environment, we are actively looking to increase exposure to volume-linked assets, with strong cash flow profiles which are able to deliver returns through the current environment.

Within corporate markets, mergers & acquisitions activity has begun to pick up, with several themes evident. Most notably, 'natural resources' companies, who are flush with cash following pockets of commodity price strength leading deal activity. Corporates are also driving an increasing proportion of aggregate deal flow as private equity sponsors remain on the side lines (relatively speaking). Driving corporate activity is a continued desire from shareholders for simpler businesses, as well as a modest tick up in activist activity. Of the private equity sponsor activity, a material proportion has been 'take privates', where a sponsor de-lists a public company. 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, we continue to see sponsors invest in their operational capability to drive operating performance. Finally, given the strength of the rally in listed equities over the last six months, we expect valuations to lift into H1 2024 given the strength in tradable comparables.

Sector and geographical dispersion remains elevated within Real Estate markets. Our focus remains on the nexus between availability of capital and valuations. Transaction volumes remain weak, both domestically and in our preferred offshore markets. Furthermore, of the limited transaction volume we are seeing, cap rates are continuing to trend lower from current marks. We do expect the magnitude of mark downs to moderate in 2024, which should support deal activity later in the year and into 2025. Much has been written about the current issues facing the office sector, however we believe the next test will be whether Industrial assets valuations can be supported as the cost of debt increases. Any weakening may provide a more attractive entry point. Looking forward, we are focused on whether there are opportunities in markets which had been early sufferers from 're-pricing' (e.g. Western Europe), although we don't expect to make any near term allocations.

Changing market dynamics (inflation, path and pace of interest rates, softening across certain economic indicators) warrants continuous reassessment of our thinking, outlook and subsequently, portfolio positioning. We continue to see dispersion within equity and credit markets, as well as divergence in the macroeconomic regime facing many economies globally. As such, we made two new hedge fund allocations during the quarter across Global Macro and Long / Short Equity, which were funded by reducing our allocation to Global Asset Allocation strategies.

Income alternatives

Positive sentiment experienced over Q4 2023 continued into Q1 2024. We saw a pick-up in mergers and acquisitions activity which is accretive to credit formation across debt market. Divergence in asset quality was noted, particularly for deals minted in the pre vs. post rate-rise environment. For older private debt deals we have seen a variety of repayments, defaults, amend and extend activity. For deals completed in the post rate-rise environment, we have seen increased discipline in underwriting standards; more reasonable collateral valuations and improved loan covenants. However, we have seen some erosion in standards more recently as investor capital comes flooding back into the market chasing the same deals.

On the public markets side, both US Leveraged Loans and US High Yield posted positive returns over the quarter, supported by the broad spread compression across other parts of credit. This is consistent with our underlying portfolio exposures which have contributed positively to performance. Interestingly we have seen the underlying asset quality of High Yield improve over the quarter and investors increasingly rewarded cash-flow positive companies with resilient earnings. US Leveraged Loans saw an improvement in market activity in-line with the increased mergers and acquisitions activity.

Despite the traditional differences, today there is a blurring of lines between private and public markets transactions. Asset class demand for private debt has been so large that companies which have historically financed through public market have increasingly gone private. We attribute this to 2 key factors 1) the bilateral/club style negotiation of private debt deals reduces the execution risks faced by companies looking to refinance and 2) demand for private debt is so prolific against a limited pipeline of supply means cost-of-debt metrics may sometimes be better in private markets vs public. Point 2 is contentious as participation is these types of deals effectively mean we get paid less for the risks we take; but we would caution that this is a general observation, and details may vary on a deal-by-deal basis.

Within private debt, we split our universe into corporate debt strategies and asset backed strategies. Our corporate debt exposure across portfolios today are primarily first lien senior secured loans diversified across Europe, North America, and Australia. So far, default experience has been limited and we expect this to continue so long as interest rates remain elevated. Within the asset backed exposure, which we favour, we have recently seeded an active domestic warehouse finance strategy targeting a return of cash+6%. The strategy delivers monthly income returns and are thus accretive to the income objectives of the strategy. Acknowledging the risk characteristics of the exposure we will still seek to limit position sizing.

Going forward, our research efforts are currently focused on liquid income alternatives. The objectives we are looking to solve here a three-fold. Firstly, we are seeking a counter-cyclical liquidity exposure which is ideally uncorrelated with credit risks. Secondly, the position needs to be distributing in support of our income objectives. Thirdly, it needs to still meet our return objectives. We are currently actively reviewing strategies within the scope of trade, invoice and insurance premium financing which may potentially meet these requirements. Liquid investments provide some optionality for reinvesting back into private assets, such as private debt or insurance linked strategies.

Fixed Income

The domestic monetary landscape continues to be driven by a concerted focus on preventing an inflation expectations feedback loop. Additionally, a strong labour market has increased the primacy of the Reserve Bank of Australia's (RBA) inflation targeting mandate. Over the quarter, indicators of inflation broadly came in in-line with the RBA's expectations. As such, the Australian yield curve was relatively stable over the period, with Australian 10-year bond yields increasing a meagre 0.011%.

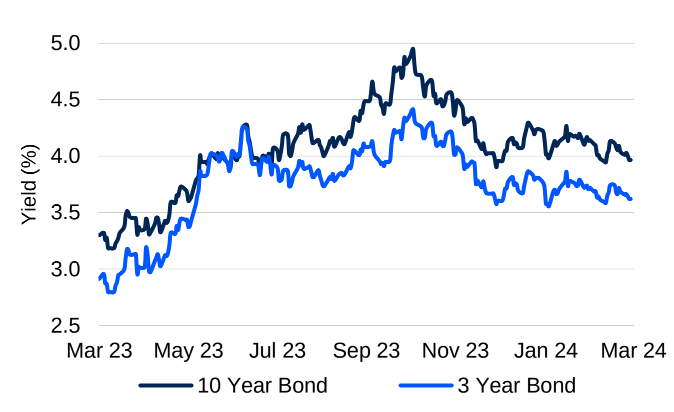
During the three months, the Bloomberg AusBond Composite 0+ Year index returned 1.1%, a figure almost entirely accrued to income. Meanwhile, the AusBond Credit 0+ Year index returned 1.4% with some benefit from a tightening of credit spreads (a reflection on a growing belief in an economic soft landing), though also enjoyed returns primarily driven by income accrual.

Considering the delicate balance present in RBA's monetary policy decisions, the Board reflected in its statement on its March Monetary Policy Decision that "While recent data indicate that inflation is easing, it remains high. The Board expects that it will be some time yet before inflation is sustainably in the target range. The path of interest rates that will best ensure that inflation returns to target in a reasonable timeframe remains uncertain and the Board is not ruling anything in or out."

Casting our attention internationally, the situation is somewhat more nuanced, with certain economies displaying robust resilience in economic terms whilst others, particularly in the UK and Europe, experiencing more imminent indications of economic softness. Indeed, with Europe arguably closer to interest rate cuts than many other regions it is notable to observe that the European 10-year bond yield increased 0.295% in the quarter as the European Central Bank (ECB) surprised the market with continued data dependency. Indeed, in a speech made in March by ECB Board member Piero Cipollone, he noted "If incoming data confirm the scenario foreseen in the March projections, we should stand ready to swiftly dial back our restrictive monetary policy stance. Increased confidence in a timely return of inflation to our target should then allow forward-looking information to regain prominence in our reaction function".

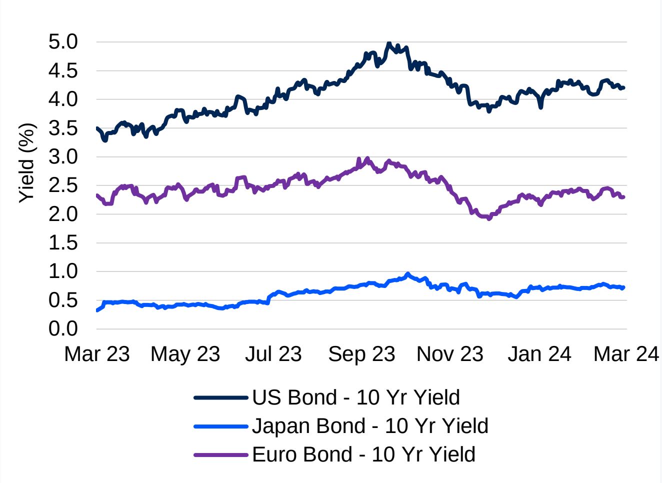
Despite the different underlying economic conditions, the clear delay to imminent cuts across major regions had the effect of pushing global yields higher, driving the Bloomberg Global Aggregate down by 0.3% over the period.

Figure 14: Australian government bond yields



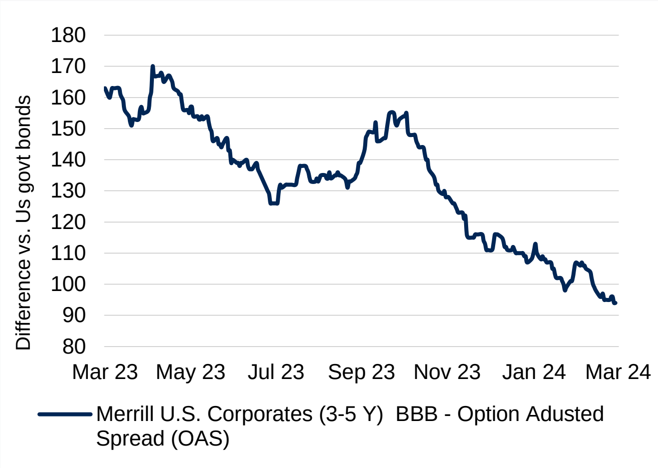
Source: FactSet, Perpetual Private
Note: Bond prices are inversely correlated with bond yields.

Figure 15: Global government bond yields



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

Figure 16: Global credit markets



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

Fixed Income Outlook

When reflecting on the last quarter of 2023, we highlighted a continued market sensitivity to central bank policy actions with an expectation that inflationary pressures are likely to persist. So far, that outlook has proven consistent with what we have seen in early 2024.

Discussions with fixed income investment managers highlight a substantial divergence in market views which can be generalised into two groups;

1) Asset managers who believe interest rate cuts are imminent as market shifts back to the low inflation, low interest rate environment experienced post financial crisis.

2) Asset managers who believes structural market changes mean interest rates are likely to stay higher for longer.

Our outlook remains more aligned with the latter but we would also add that central bankers are adaptive by nature and are unlikely to make the same policy mistakes as has been experienced in the past. As it relates to credit, we would summarise the managers outlook as cautiously optimistic. Our comments reflect observed portfolio positioning where investment managers have continued to maintain a marginal overweight to credit but have also bought downside protection hedges in the form of credit default swaps.

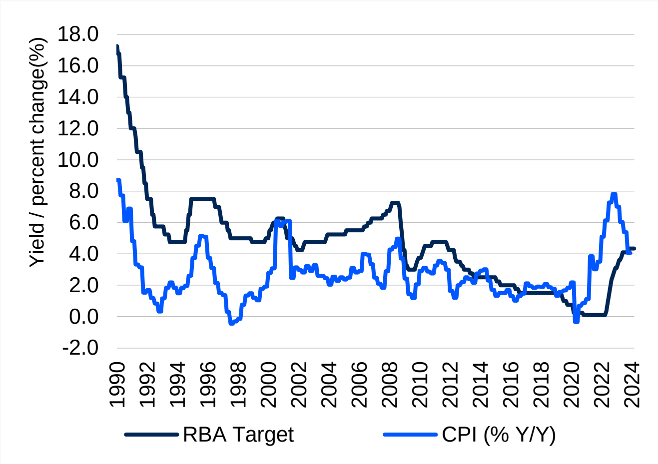
The beginning of 2024 saw the return of investment confidence supported by more benign economic conditions. Australian and US government bond yield curves imply an expectation of interest rate cuts over the next 2 to 3 years; but this has begun to shift over the quarter as inflation proved stickier than expected. We continue to expect inflation levels to stay close to the higher end of central bank target range at approximately 3%, and this will in turn likely see central banking committees hold off any interest rate cuts over the short-term.

Policy rates have generally remained steady in the last 2 quarters (with the exception of RBA raising rates in Nov 2023) and companies have adjusted to the higher interest rate environment. We have seen rationalisation of the labour force which has supported corporate earnings growth despite higher debt payments. For Investment Grade markets this has been received positively and has led to a compression in corporate spreads. Additionally, there has been strong demand for Investment Grade credit by investors seeking yield. For some cohorts (primarily insurance and defined contribution pension schemes), the high absolute level of yield provides a strong incentive to increase exposure in the segment, irrespective of tighter spreads. This is different in the lower rated non-investment grade market where default rates have ticked higher. The marginal increase in credit defaults is happening primarily in the B/CCC rated part of the universe leading to spread widening. We continue to keep our risk budget relatively low, leaning into exposures with shorter maturities.

Australian Cash Rate

The Australian cash rate has been on hold since the RBA Board increased it by 0.25% at the November meeting last year. As we know, this is following a multi-decade downward trend in the cash rate, that ultimately bottomed in November 2020 at 0.10%, when the RBA sought to soften the impact of the pandemic. It was held there until May 2022, when the RBA was forced to pivot in order to address rampant inflation. The moves from the bank were subsequently aggressive as the Board sought to ensure that inflation did not become a self-reinforcing feedback loop. In only 10 meetings, interest rates were lifted from 0.1% through to 3.6%. Fine tuning brought this up a further 0.75% to where it stands today at 4.35%. Having tightened significantly in such a short period of time, and recognising the long and variable lags monetary policy has on an economy, the RBA's position is now more akin to a 'wait and see' data dependency approach.

Figure 17: Long-term cash rate vs inflation



Source: FactSet, Perpetual Private.

Australian Cash Rate Outlook

As we look ahead, the path of interest rates is uncertain. Whilst inflation has come down significantly from its highs in 2022, it remains stubbornly above target. Indeed, a confounding feature of the current environment is that despite the significant degree of monetary tightening, the economy has remained relatively strong, with services driven inflation reflecting a surprisingly high degree of consumer confidence. Our inclination, along with most other observers, is that the next move, whenever it comes, is likely to be downwards. We do however caution, that this is by no means a certainty. The RBA has made clear that solving inflation is the priority. Indeed, taken from the Board's statement following the March meeting this is laid out in no uncertain terms. In their own words "While recent data indicate that inflation is easing, it remains high. The Board expects that it will be some time yet before inflation is sustainably in the target range. The path of interest rates that will best ensure that inflation returns to target in a reasonable timeframe remains uncertain and the Board is not ruling anything in or out. The Board will rely upon the data and the evolving assessment of risks."

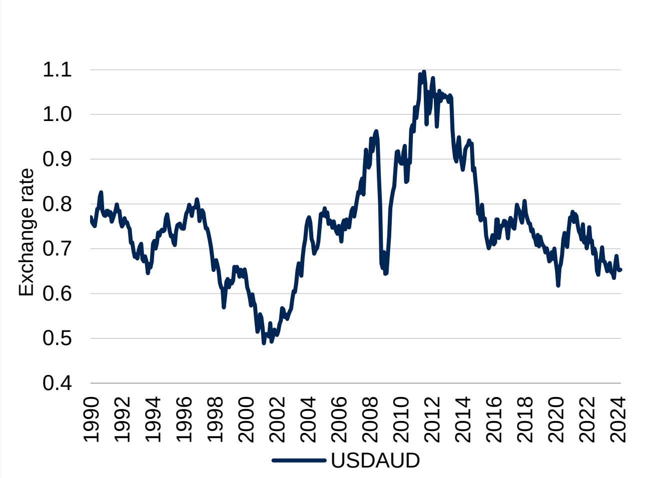
Australian Dollar

The Australian dollar (AUD) softened against the U.S. dollar (USD) over the quarter, giving up some of the gains enjoyed at the end of 2023. Having moved up from the 63 cent mark in October, rallying all the way to 68 cents, it ended March at 65 cents. Indeed, 65 cents is not only the middle of Q4 trading range, but also very close to the mid-point of its 12-month trading range. The primary reason for the softness centres around the evolving outlook for interest rate changes. The prospect of the RBA cutting rates before the US Federal Reserve is gaining traction. This is a shift from earlier this year, when market experts anticipated the Fed to move first.

Whilst the implication was the same (i.e., that AUD softened), the drivers were different for the Pound (GBP) and the Euro (EUR). Here, the AUD again gave up its end of 2023 gains. However, as the scope for interest rate reductions in Britain and Europe were already well entrenched, the focus was more on economic outlook. With Australia's fortunes intimately tied with that of China, and the EU and UK inch closer to providing economic stimulus, the EUR and GBP gained 2.3% and 3.5%, respectively.

Interestingly, the implications for Australia aren't consistently negative. Against the Japanese Yen (JPY) and Swiss Franc (CHF), both traditionally 'safe haven' currencies, AUD gained by 2.7% against JPY and 2.5% against CHF.

Figure 18: USD per AUD – Long-term exchange rate



Source: FactSet, Perpetual Private.

Australian Dollar Outlook

Our focus tends to be on the medium-to-long-term outlook for the Australian dollar, as short-term forecasts can be difficult due to the currency's sensitivity to trade flows and momentum. Looking ahead, the AUD faces potential downward pressure. Continued US economic strength and persistent inflation might lead investors to delay expectations of Federal Reserve rate cuts, increasing the likelihood that the RBA will cut rates first. Additional headwinds could emerge from ongoing concerns about China's economic slowdown and potential policy shifts by the US and other key trading partners of Australia.

Authors

Andrew Garrett, CFA CAIA
Investment Director, Perpetual Private

Hugo Goode
Investment Associate, Perpetual Private

More Information

1800 631 381
perpetualprivate@perpetual.com.au
www.perpetual.com.au/advice

Trust is earned.

Perpetual