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WEALTH MANAGEMENT
Financial Advisers

QUILLA

Quarterly Investment Insights

July 2024

Welcome

The halfway point of the year is a good time to take stock of some of the key economic and financial market issues at hand, while also looking ahead at what markets are expecting and opportunities.

Key topics

- **Global economic growth**
- **The US and Australian inflation trajectory**
- **Equity markets – performance drivers and expectations**
- **Investment opportunities in interest rate-sensitive sectors**

Global economic growth

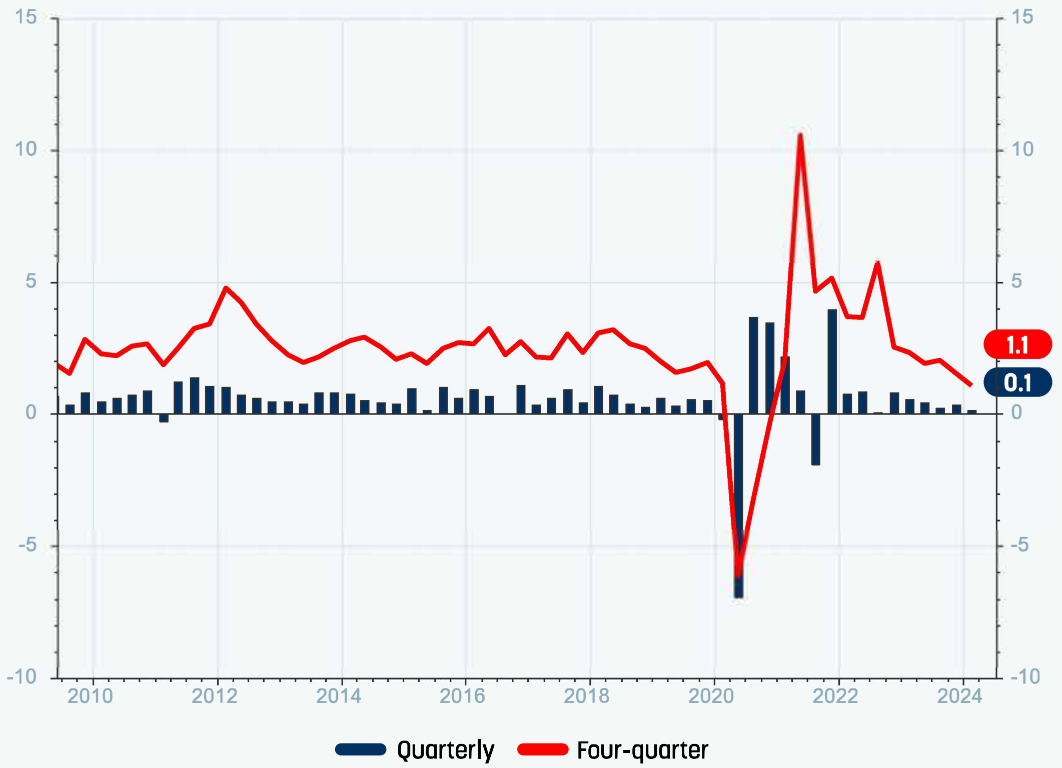
The global growth trajectory across regions has been diverse as they find themselves at different stages in the economic, business, and interest rate cycles. The levels of economic activity have been impacted by interest rates and the degrees to which consumers and industry have been able to absorb interest rate hikes and elevated inflation.

A weakening of Australian growth

The Australian economy has been resilient and continues to expand slowly, driven by government and private business spending, and the effects of increased net migration. While GDP growth remains modest (Chart 1), it has been adequate to forestall significant deterioration in the labour market.

The most recent 1.1% GDP growth rate for the Australian economy was the weakest since the mid-1990s, continuing a declining growth trend and precariously heading towards recessionary levels.

Chart 1: Australian GDP Growth



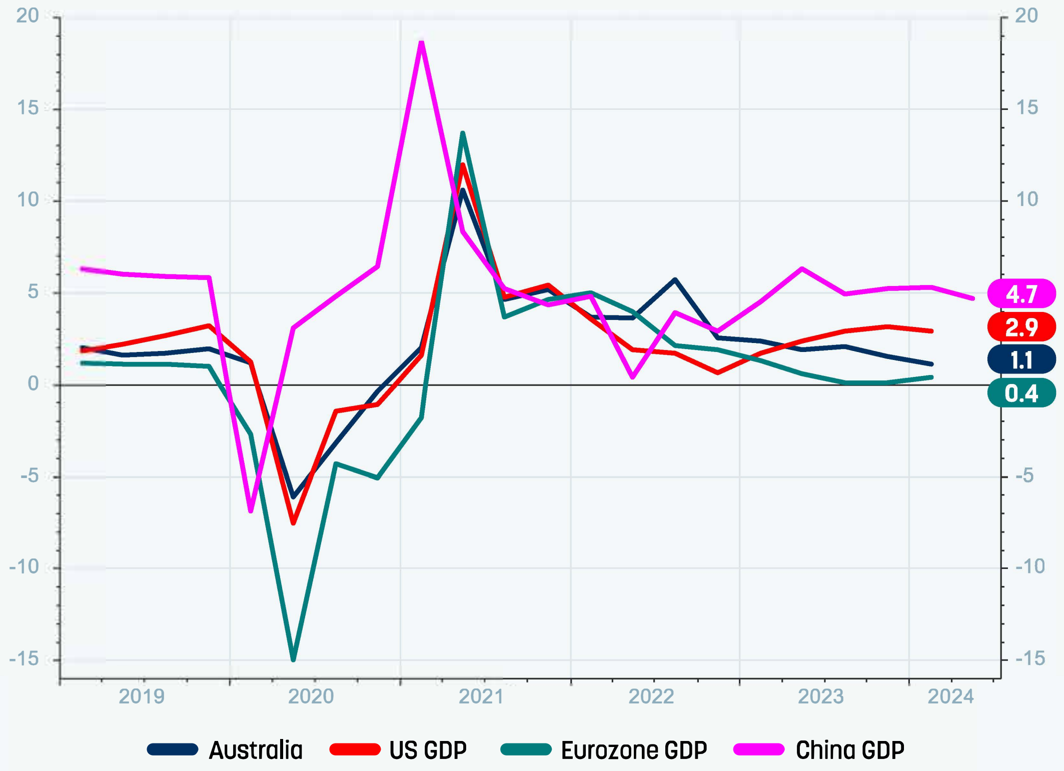
Source: LSEG Datastream, Quilla Consulting

The United States (US) economic engine

The US economy continues to lead the way in developed markets, driven by a resilient consumer and a US-led improvement in global manufacturing activity. The strength of the US economy has been a highlight of the first half of 2024 with consumer spending and business activity supporting a robust labour market.

There are, however, signs of an economic slowdown in the US, as forward-looking indicators show that the US economy is beginning to decelerate.

Chart 2: Major Economies' GDP Growth Trends



Source: LSEG Datastream, Quilla Consulting

A weak European economy

The weakness in the European economy has meant that inflation has moderated faster than other major economies and has allowed the European Central Bank (ECB) to cut policy rates sooner.

Chinese property remains a headwind to growth

The Chinese economy has surprised economists in the first half of the year with GDP tracking ahead of expectations. The slowdown and deleveraging within the Chinese property market have weighed heavily on sentiment towards China as well as overall economic growth.

The Chinese authorities have ramped up support for the economy in the first half of 2024 with policy and support measures implemented across the share market, property market, and overall economy.

The US and Australian inflation trajectory

Investors had a laser focus on inflation in both Australia and the US in the first half of 2024, the trajectory of which dictated the tone of central bank policy meetings and the expected path of interest rates.

At the beginning of the year, markets were very optimistic about the trajectory of future rate cuts, expecting up to six cuts in the US in 2024 based on the expectations of lower inflation figures. However, the stickiness of inflation measures has tempered expectations around the size and timing of rate cuts.

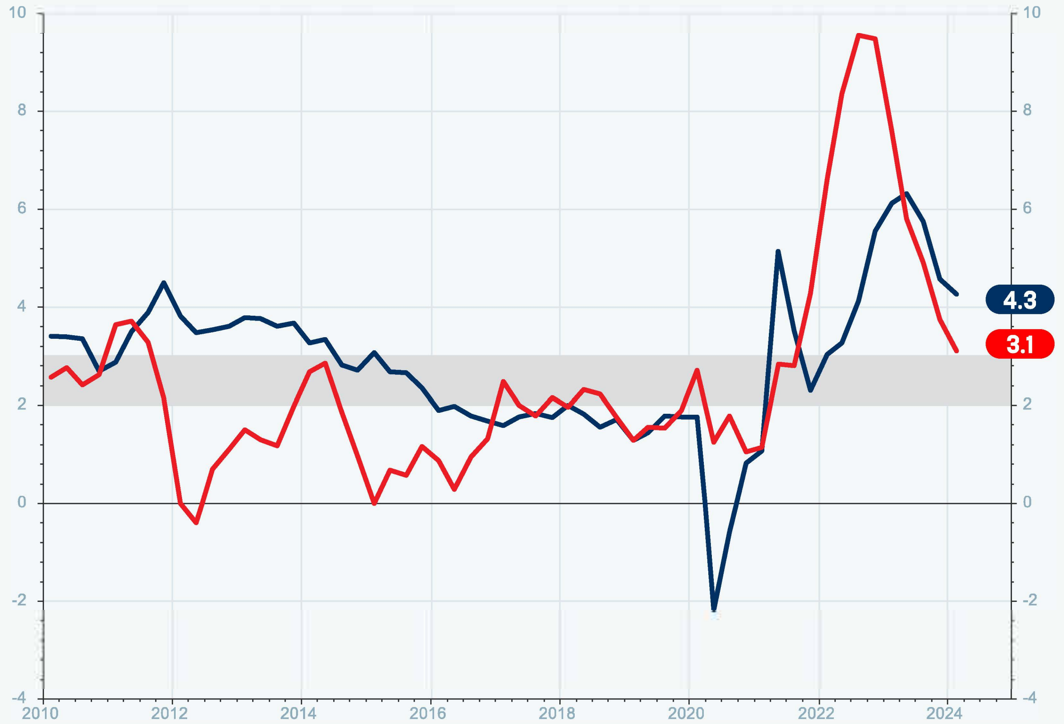
Australia's sticky inflation

Chart 3 shows the battle with sticky services inflation (blue line) in Australia. The final stretch of the battle with inflation is particularly challenging due to mechanical factors, such as base effects and entrenched wage expectations in sectors with high costs and lower productivity.

Core services inflation in Australia is hovering around 4-6% (Chart 3), propelled by robust wage growth which is approximately twice the rate observed before the Covid-19 pandemic. This persistent inflationary pressure is presenting challenges for the Reserve Bank of Australia (RBA) who is only expecting that inflation will reach the target range (2-3%) in late 2025.

An uptick in unemployment could dampen wage growth and contribute to disinflation. Leading indicators, like the NAB Business Confidence Survey, suggest that unemployment may soon begin to increase.

Chart 3: Australian Inflation – Goods and Services



Source: LSEG Datastream, Quilla Consulting

US inflation moderates slowly

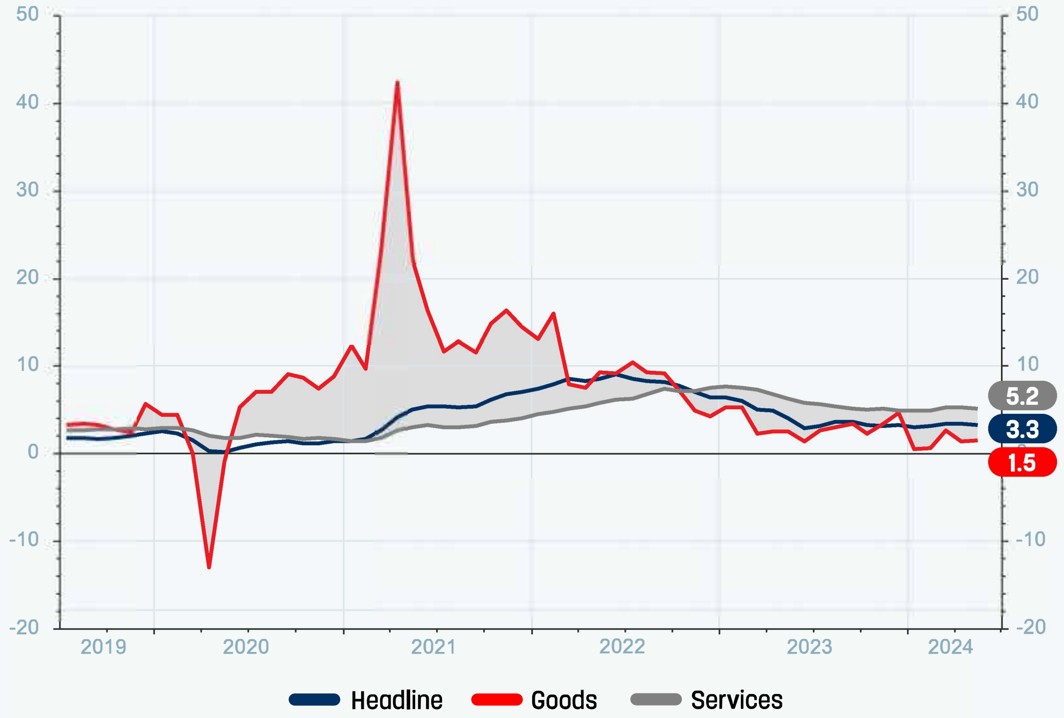
US inflation has moderated towards the Federal Reserve's (Fed) target of 2.5%, albeit at a slower pace than markets had initially expected at the beginning of the year.

Australian inflation measures have surprised to the upside recently, whereas US inflation has remained more tepid and in line with expectations. This inflation divergence has been driving divergent interest rate path expectations.

Markets are now pricing in a 65% probability of an interest rate cut in the US at the September Fed meeting. In contrast, economists are now pricing in a 50% chance that the RBA will increase in the cash rate in the second half of this year.

Chart 4: US Inflation Goods and Services

Twelve month percentage changes



Source: LSEG Datastream, Quilla Consulting

Equity markets – performance drivers and expectations

Global equity markets have produced solid investment returns so far for 2024, despite the uncertain path of interest rates. Many developed and emerging markets have traded at all-time highs, including the Australian and US share markets, despite precarious economic conditions. The old financial markets adage that the stock market is not the economy has been very apt in 2024.

The US stock market has significantly outperformed most other stock markets globally since the Covid-19 pandemic.

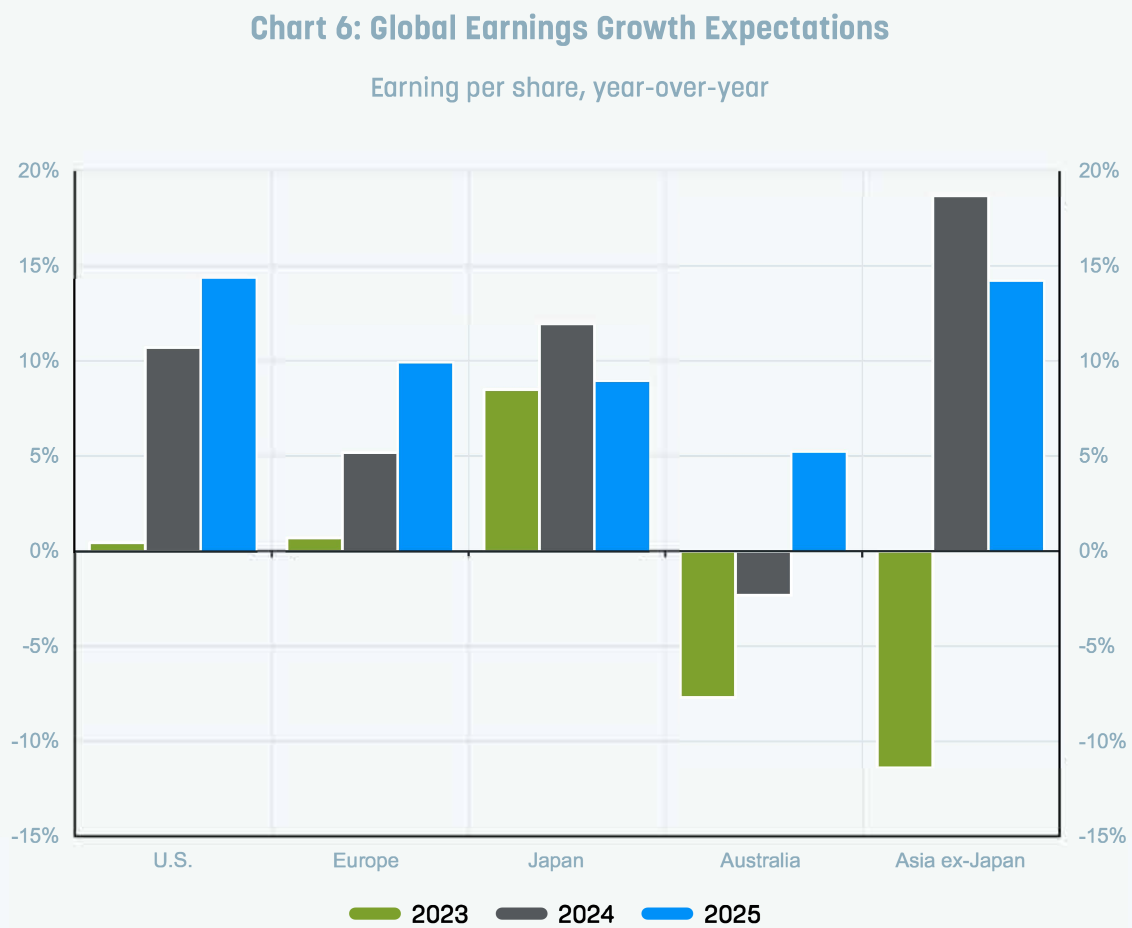
Chart 5 shows that since 2019 the MSCI AC World Ex USA has seen price and earnings grow by approximately 15%, whereas the MSCI USA Index has grown earnings by 42% while its price has risen by approximately 170%.

Growth in US EPS has consistently grown at a faster pace than the rest of the world, hence we are more positively disposed to US equities due to the more attractive structural earnings outlook.

Chart 5: MSCI USA vs MSCI World Ex US (Price and Earnings per share (EPS))

Earnings forecasts illustrated in Chart 6 show a broad and significant improvement across global markets over the next two years. The outlier is Australia, where aggregate earnings are expected to be negative for 2024 with only modest earnings improvements expected for 2025.

Asia ex-Japan is expected to produce the strongest growth in earnings in 2024 and is the only region where earnings growth is expected to outpace that of the US in 2024, and closely match it in 2025.



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. Guide to the Markets - Australia. Data as of 12/07/24.

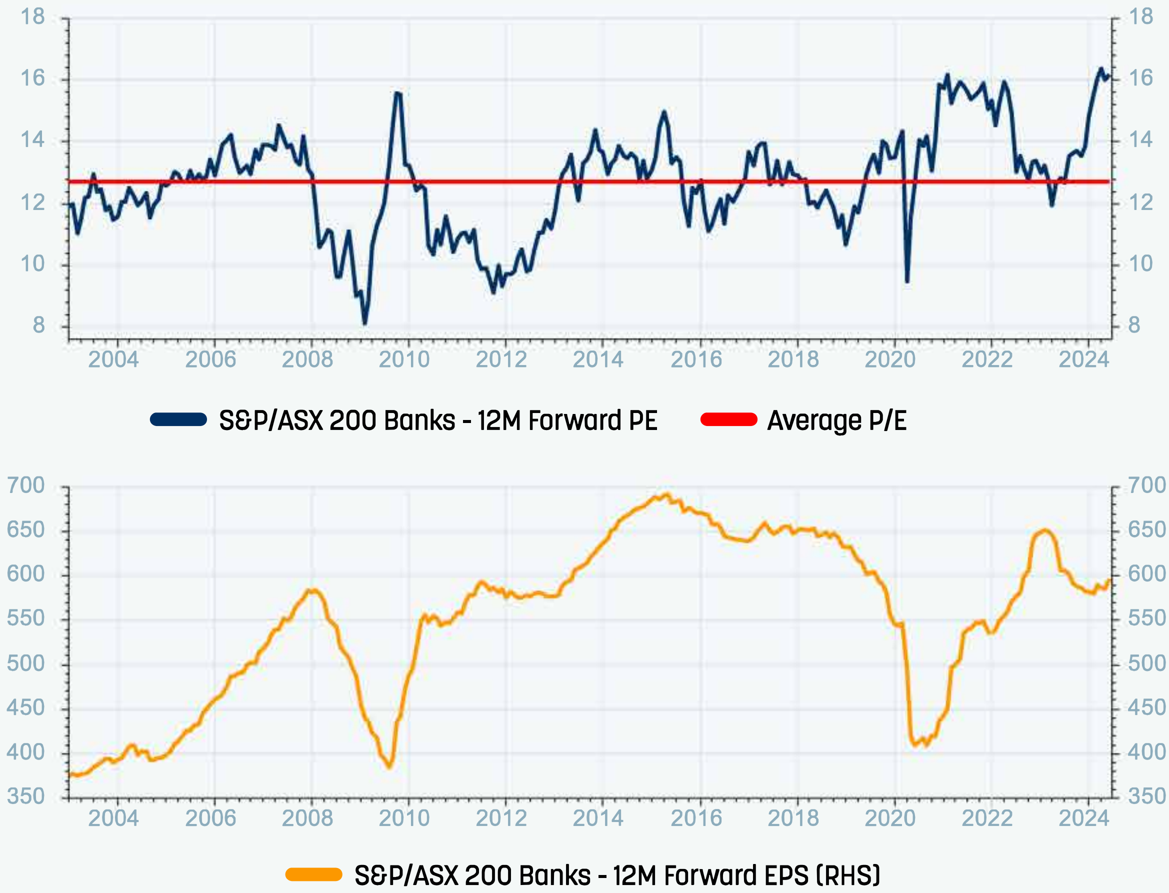
Chart 7 (blue line) shows the price to earnings ratio (P/E) over time of the ASX Banks Index. The P/E ratio is a common company valuation measure indicating the price paid for a share relative to the earnings generated by the company.

Australian banks have enjoyed a strong rally since 2023 and that has led to the current P/E ratio rising to historically high levels and well above the historical average. However, over this period, earnings estimates have been decreasing (yellow line). This indicates bank share prices have been rising without a commensurate increase in bank earnings.

The Big 4 banks have a large weighting in the ASX200 Index, currently comprising approximately 22%. Materials also have a significant weighting in the index of around 20%. Earnings growth estimates for the materials sector are also muted looking ahead to the next 12 months.

We remain cautious on Australian equities and positive on global equities. We are becoming more constructive on emerging market equities, of which Asia is a large component.

Chart 7: ASX Banks – 12M Forward P/E (top) and Earnings Per Share EPS (bottom)



Investment opportunities in interest rate-sensitive sectors

US Real Estate Investment Trusts (REITs) are a significant portion of global property benchmarks and have underperformed the broader market over the past decade. Key factors driving this underperformance include:

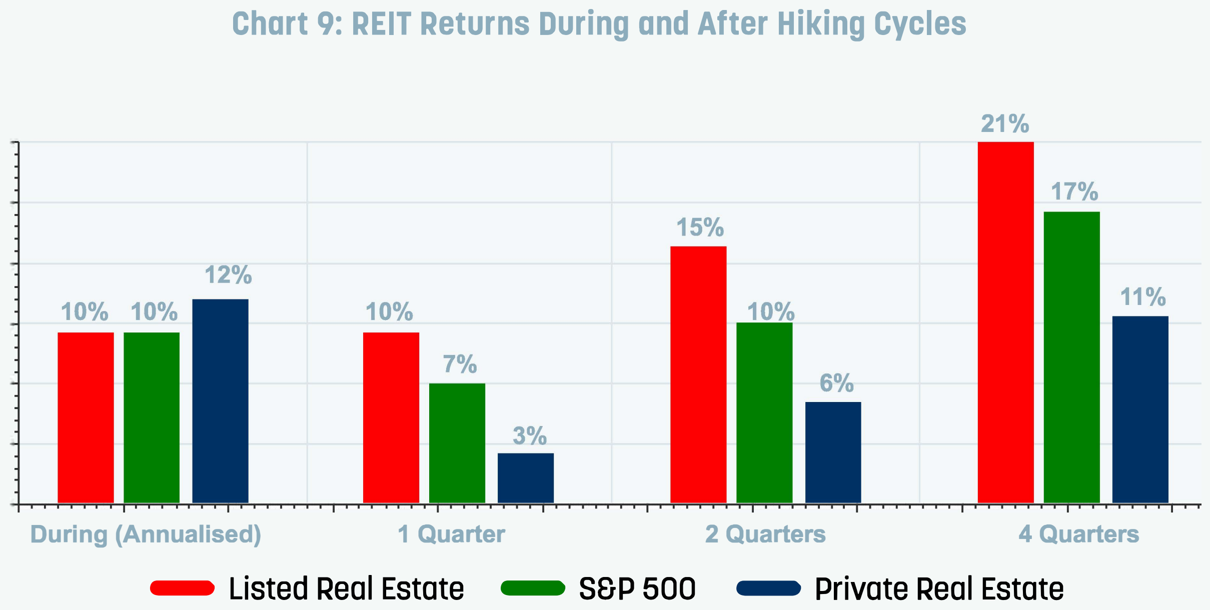
1) weaker relative earnings compared to non-property related stocks;
2) the emergence of the FAANGs and Magnificent 7;
3) Covid-19; and
4) interest rate hikes.

Relative valuations for US REITs against the broader market are at 20-year lows, despite a recent improvement in earnings (Chart 8 - top).

Both Commercial and Residential property prices (Chart 8 - green and red lines) have also recovered from their lows in 2023 which may improve sentiment towards the property sector.

Chart 8: S&P Real Estate: Earnings Growth (top) and Price Growth (bottom)

With the hiking cycle in the US likely over, US REITs may enjoy a recovery in performance as they have done in previous cycles (Chart 9).



Source: LSEG Datastream, Quilla Consulting

Outlook

As we cross the halfway point of the year, it's essential to assess the varied dynamics influencing financial markets. Looking ahead, the investment landscape suggests a cautious approach to Australian assets, while maintaining a positive outlook globally. The anticipated start of the US interest rate cutting cycle presents further investment opportunities, particularly for interest rate sensitive sectors.

In this complex environment, astute portfolio positioning and vigilant monitoring of economic and market indicators will be crucial in navigating the opportunities and challenges in the months to come.