Monthly Market Commentary with Portfolio Manager, Andrea Ciaccio

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Market Review

After briefly touching 5% in October for the first time since July 2007, the US 10 year yield abruptly dropped 50 Bps during the first two weeks of November on the back of reduced government borrowing estimates for Q4 2023 and the US Department of the Treasury's decision to issue most of the debt in the form of bills rather than "coupons". Then, on November 14th, the Bureau of Labor Statistics (BLS) data showed that the US CPI decelerated to +0.0% MoM and +3.2% YoY in October, missing expectations of +0.1% and +3.3%, while the so-called US CPI Core, which excludes the more volatile food and energy components, came in lower than expected at +0.2% MoM and +4.0% YoY, against estimates for +0.3% and +4.1%. Bond markets cheered the good news on inflation, with the 10 year yield declining almost 20 Bps in a single day on the prospect that the FED may be done raising interest rates.

On November 27th, Christopher Waller, considered to be one of the most influential voting member of the FOMC and known for his relatively hawkish views, gave a speech entitled "Something Appears to Be Giving" at the American Enterprise Institute (AEI) hinting that the long-awaited pivot of the FED may be finally in sight. He started by stating that "inflation rates are moving along pretty much like I thought", giving him increased confidence that "policy is currently well positioned to slow the economy and get inflation back to 2%" and, most importantly, without the need of a "full recession". In that regard, he observed that, so far, the unemployment rate has gone up only to 3.9%, and it "will probably go up a little bit more, but if we can get inflation to come down, GDP growth to soften but not go negative", he is "reasonably confident that we can pull off this soft landing". He then suggested for the first time that the clock may be ticking on the timing of the first cut. In fact, during the Q&A session, he stated that if the decline in inflation continues "for several more months", "three months, four months, five months", the central bank "could then start lowering the policy rate just because inflation is lower". He explicitly emphasized that "it has nothing to do with trying to save the economy, or recession", but it is just "consistent" with monetary policy rules in that "if inflation goes down, you would lower the policy rate" as "there's just no reason to say you would keep it really high, and inflation's back at target". In other words, Waller appeared to signal that the target rate may have finally reached restrictive territory, and that, going forward, the FED may be shifting its framework toward targeting "real rates", that is, the difference between the target rate and the rate of inflation, as opposed to "nominal rates", that is, the absolute level of the target rate.

Bond yields slid further following Waller's remarks, with the US 10 year yield ending November at 4.33%, down 60 Bps since the end of October, its biggest monthly decline since December 2008. The iShares 20+ Year Treasury Bond ETF, a popular benchmark to track the performance of long duration strategies, which had lost close to -15% in the first 10 months of the year, jumped +9.92%, its 5th best month ever, outperforming the SPDR S&P 500 ETF. Stock markets around the world rallied sharply, while the Dollar Index (DXY) dropped the most since November 2022. As a result, the Goldman Sachs US Financial Conditions Index recorded its largest monthly loosening in history, ending roughly at the same level it was back in June 2022, when the target rate was at 1.50%-1.75%. In summary, November saw an almost complete reversal of the increase in long-term yields which occurred between September and October, a rise that, in the words of Chairman Powell, was "producing tighter financial conditions" at that time, thus potentially lessening the need for further hikes on the part of the FED.

International Equities

The fear of "higher for longer" melted away in November, with the steep decline in yields fuelling a furious stock market rally. The S&P 500 (+8.92% in USD terms) and the Nasdaq 100 (+10.67% in USD terms) recorded their 6th and 8th best Novembers ever and their best month since July 2022. Both indices recovered the double-digit losses suffered between July and October in the space of a month. The Nasdaq 100 rose to its highest level for the year, breaching above its July peak and ending just -4.87% below its all-time high from November 2021. Similarly, at the end of the month the S&P 500 was trading just -5.21% shy of its all-time high from January 2022. The appetite for risk returned with the S&P 500 High Beta TR outperforming the S&P 500 Low Volatility TR by the largest amount since January, as traditional defensives such as consumer staples, utilities and healthcare lagged. However, the S&P 500 High Dividend Index TR rose the most since October 2022 and outperformed the general index on the back of the significant drop in the risk-free rate. Technology was the best performing sector, with the so-called "Magnificent Seven" group of tech stocks (Apple, Microsoft, Nvidia, Meta (Facebook), Amazon, Alphabet (Google) and Tesla) hitting a new all-time high. Sentiment swung abruptly from fear to extreme greed, igniting a powerful recovery in the most speculative high growth and leveraged names. The Bloomberg Galaxy Crypto Index and the Goldman Sachs Non Profitable Tech Index were both up in excess of +20%, while the Red Rocks Global Listed Private Equity Index TR recorded its 2nd best month ever. Interest rate sensitive sectors that had been struggling since the collapse of Silicon Valley Bank back in March caught a bid. The S&P Regional Banks Select Industry Index TR recorded its 11th best month in history and the Real Estate Select Sector Index TR posted double-digit gains, leading financials to outperform the S&P 500. Conversely, energy bucked the trend as oil prices declined for the second consecutive month, down -20.07% from their September highs. The VIX Index, the measure which estimates the expected volatility of the S&P 500, got crushed, closing below the 13 level on a monthly basis for the first time since November 2019, before the pandemic. US equities beat the rest of the world for the second month in a row, despite the MSCI AC World ex USA TR Index recording its 10th best month ever. Europe topped the list, driven higher by Germany. In Japan, large cap growth stocks led the Nikkei 225 to its highest level in 33 years despite a sluggish domestic macroeconomic backdrop. China weighed on emerging markets, as the Shanghai Shenzhen CSI 300 Index and the Hang Seng China Enterprises Index were down and flat respectively for the month. Argentina was the best performing country after the self-described "anarcho-capitalist" Javier Milei won the presidential election. South Korea ripped higher after the government banned short selling in the stock market until June 2024. All in all, the MSCI AC World Daily TR was up +9.23% in USD terms (7th best month in history) and +4.83% in AUD terms. Finally, the MSCI World Growth Index recorded its 8th best month ever, topping the MSCI World Value Index for the 8th month out of the last 11, while the MSCI ACWI Small Cap Net TR Index recorded its 8th best month ever, marginally outperforming the MSCI ACWI Large Cap TR Index.

Australian Equities

Australian equities surged in November, led higher by healthcare, technology, A-REITs and industrials. Index heavyweight CSL rebounded from its 2023 lows, rising double digit for the month. Miners were supported by the continued recovery in the price of iron ore. In addition, copper interrupted a three-month losing streak, while gold closed above 2,000 USD per troy ounce on a monthly basis for the first time in history. 3 of 11 sectors were in the red, namely energy, consumer staples and utilities. The latter group was adversely affected by the decision of Australian Super, Origin Energy's largest shareholder, to reject the new Brookfield-led consortium's offer to buy Australia's biggest energy retailer. Value stocks bested growth stocks, while mid-caps and smaller companies strongly outperformed the Top 20. Finally, the MSCI Daily TR Net Australia outperformed the MSCI AC World Daily TR.

International Fixed Interest

Every major global central bank that met during the month left interest rates unchanged. Those include the FED, the Reserve Bank of New Zealand (RBNZ), the Norges Bank, Norway's central bank, the Riskbank, Sweden's central bank, and the Bank of England (BOE). In Japan, Governor Ueda pushed back against market expectations of the BOJ ending the negative rates regime before the end of the year, despite domestic inflation being on track to exceed the 2% CPI target for the second year in a row. The trajectory of monetary policies pursued by major emerging market economies continued to diverge in November. However, the number of rate cuts outstripped that of rate hikes for the first time since February 2021. Central banks in Hungary and in Brazil extended their easing cycle, while only the Central Bank of the Republic of Turkey (CBRT) delivered another monster increase (+500 Bps) to combat an entrenched inflation and a weakening currency. Government bonds were lower across the board, particularly at the long end. In US, the 10 and 30 year yield fell the most since December 2008 and September 2011 respectively, causing the yield curve inversion to deepen for the first time in 5 months. In Europe, the Bloomberg Euro Government Index recorded its 4th best month ever as inflation came in lower than expected at +2.4% YoY, against estimates for +2.7%. Credit spreads tightened, with both the iBoxx USD Liquid Investment Grade TR Index and the Bloomberg Global CoCo Banking Statistics Index recording their 2nd best month ever. The Bloomberg Barclays Global Aggregate Index hedged back to AUD (+3.20%) recorded its 3rd best month ever, swinging back into positive territory since the beginning of the year.

Australian Fixed Income

On November 6th, the RBA increased the cash rate by a widely anticipated 25 Bps to 4.35%, its highest level since November 2011. In the accompanying statement, Governor Bullock surprised the market with a dovish bias by stating that "whether further tightening of monetary policy is required will depend upon the data and the evolving assessment of risks". Following the decision, the cash futures moved to price out the final hike that was expected to be delivered sometime between Q2 and Q3 2024. The Australian yield curve "bull flattened" in response, with the 2, 5 and the 10 year yield declining 35 Bps, 46 Bps and 52 Bps to 4.11%, 4.07% and 4.41%. The Bloomberg AusBond Composite 0+ Yr rose +2.97%, returning into positive territory since the beginning of the year. The Australian Dollar strengthened vis-à-vis all major developed and emerging currencies, ending November above 66 cents against the US Dollar.

Real Assets

Global property rallied +10.07% in USD terms and +5.64% in AUD terms for the month. All regions posted positive returns. Europe topped the list despite Signa Holdings, Austria's largest privately owned real estate company, filing for insolvency. Similarly, the office sector performed in line with the index notwithstanding the bankruptcy of global coworking space provider WeWork.

Global infrastructure jumped +9.07% in USD terms and +4.68% in AUD terms in November. Telecommunication infrastructure and toll roads were the top performers as they benefited from solid Q3 results and the downward movement in rates. Renewable energies and utilities posted strong gains, but the latter group could not keep up with the index.

Alternatives

Returns for Alternatives (+1.01%) were mostly positive across strategic mandates in November. Long/Short equities managers led gains, followed by Event Driven. Conversely, discretionary macro and CTA and managed futures entered the month short Treasuries and long commodities, suffering steep losses as a result.

Market Outlook

On March 17th, 2021 Chairman Powell held the usual press conference that follows every FOMC meeting. At that time, the last known inflation data was February's one, which showed that the US CPI YoY had grown +1.7% YoY. However, there were expectations of an increase in prices in the months afterwards. Chairman Powell infamously commented that "these one-time increases in prices are likely to have only transient effects on inflation". The concept of "transitory inflation" was born, and the central bank continued to run an ultra-loose policy program for another year.

In March 2022, the FED conducted its final bond purchase under the "Quantitative Easing" programme and hiked rates by 25 Bps to a range of 0.25%-0.50% but the central bank had a problem: inflation was running at +7.9% YoY and accelerating. Chairman Powell was at risk of going down in history as the new Arthur Burns, the FED Chair who let inflation run rampant during the 1970s. So, he embarked on the most aggressive tightening cycle in decades by simultaneously hiking rates and shrinking the FED's balance sheet ("Quantitative tightening"). On August 26th, 2022 at the annual Jackson Hole meeting, he declared that his responsibility to deliver price stability was "unconditional" and that the central bank was ready to bring "some pain to households and businesses" in order to achieve its aim. His forceful actions and comments reshaped his image in that of a new Paul Volcker, the central banker that took the FED target rate to 20% four times between March 1980 and May 1981, causing a recession and unemployment to spike in the process.

In July 2023, the FED put rate hikes on pause at 5.25%-5.50% but continued to harden its monetary stance via "forward guidance", that is, by talking hawkish. The concept of "higher for longer" was born. In September 2023, the central bank communicated its intention to increase the target rate by another 25 Bps before the end of the year, and to reduce it only by 50 Bps in 2024, despite projecting a decline in core inflation of 110 Bps over the same period of time. Equity and bond markets fell together, cementing Chairman Powell's reputation as a hawk.

The FOMC has just held its last meeting of the year and as pointed out buy an astute commentator, the gist of it is that Chairman Powell is neither Arthur Burns, nor Paul Volcker. He is actually following in the footsteps of Alan Greenspan, the "maestro" who pulled off the "soft landing" of the US economy in 1994-1995. In fact, during the press conference given on December 13th, he made a complete U-turn by pivoting dovish. First, he started by saying that "there's little basis for thinking that the economy is in a recession now". He then described the current monetary stance as "very restrictive" and "putting downward pressure on economic activity and inflation", and acknowledged that there is a risk "that we would hang on too long". He admitted that the FED is "very focused on not making that mistake" and that it had discussed the timing of "when will it become appropriate to begin dialling back the amount of policy restraint". Finally, he said explicitly that the central bank will cut rates "well before" the rate of inflation reaches 2%, as, should it decide to wait until the target is hit, "it would be too late". The newly released Dot Plot analysed in conjunction with the latest Summary of Economic Projections provided the same message, but in a quantitative manner. In fact, the FED has downgraded its median forecasts for core inflation in 2023, in 2024 and in 2025 to +3.2%, +2.4% and +2.2% (from +3.7%, +2.6% and +2.3%), while at the same time reducing more than proportionally its projections for the target rate to 5.4%, 4.6% and 3.6% (from 5.6%, 5.1% and 3.9%). In plain English, the FED is willing to cut more while at the same looking for inflation to come down harder and faster, that is, it is not just pre-empting the monetary stance from becoming more restrictive, it is openly aiming at loosening it at the margin by reducing, rather than holding steady, "real rates".

There is no doubt that the FED has pivoted and that its shift increases the probability of a "soft landing", as a proactive central bank is the critical factor that is required to achieve such an economic outcome. However, it is a condition which is necessary, but not sufficient. At the time of writing this note (December 19th), the S&P 500 is only -1.17% below its all-time high and credit spreads for investment grade bonds have tightened to the same level they were before the hiking cycle even began. In July 1995, Chairman Greenspan delivered the first cut in a similar, benign environment. However, we contend that today the US economy is way more financialized than it was 30 years ago, thus any easing of financial conditions will tend to flow through to consumers pretty quickly via the so-called "wealth effect". As a result, by going for the soft landing, the FED may risk reigniting the flame of inflation down the road. We think that the central bank is aware of that danger, but, in the words of Bill Dudley, the former president of the Federal Reserve Bank of New York, it is willing to take the "gamble" as it currently has the motive and the opportunity to pivot. The motive is political. The FED has been forced to increasingly coordinate with the US Treasury in managing its monetary affairs given the government's insatiable borrowing needs unleashed by "Bidenomics". In that context, the "higher for longer" narrative was too far of a stretch as it pressured the Treasury to pivot at the end of October and to finance its spending primarily by issuing bills rather than "coupons". Now it is time for the FED to pivot, as sooner or later the Treasury will have to tap the long end of the curve once again, and thanks to the huge decline in yields which occurred in the past 2 months, it will be in a condition to do so without the risk of significant disruptions. The opportunity is provided by the lagging effect of shelter on inflation being calculated on rents rather than house prices, that component of the CPI is about to drag inflation lower in H1 2024, providing the FED with the cover required to ease its monetary stance over that period of time. And that does not even need to take into account that shifting the focus from stable prices to maximum employment will be a hugely popular decision.

Putting it all together, we have started to normalize the duration of our portfolios after having been underweight for the past two years and we will continue to add to it as we expect bond volatility to subside. We think that the positive momentum for equities may persist in the first half of 2024 and that the rally may broaden from mega caps growth, fuelling a catch-up trade in the biggest laggards of 2023, primarily emerging markets and interest rates sensitive sectors. In our opinion, real assets stand to benefit the most from the pivot; for that reason, we have increased our exposure to global infrastructure and/or reintroduced an allocation to global property, subject to the various risk constraints of each single model portfolio.

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ESG pillar scores are displayed as a number between 0 and 100 with most scores range between 0 and 25. It is the asset-weighted average of the company environmental, social, governance risk scores for the covered corporate holdings in a portfolio. The scores measure the degree to which a company's economic value may be at risk driven by environmental, social, and governance factors. The risk represents the unmanaged risk exposure after taking into account a company's management of such risks.

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