Monthly Market Commentary with Portfolio Manager, Andrea Ciaccio

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Market Review

The two most anticipated events of 2023, that is, the US economy entering a recession and China experiencing a post-COVID economic boom, failed to happen. At the end of December, GDPNow, a "nowcasting" model created by the Federal Reserve Bank of Atlanta to provide a running estimate of the real US GDP growth based on available economic data for the current measured quarter, was tracking at +1.9% QoQ annualized. If confirmed, that number would follow a blockbuster +4.9% QoQ annualized for Q3, and +2.1% and +2.2% for Q2 and Q1 respectively. As a result, the Bloomberg consensus estimates for US GDP growth for the calendar year 2023 were tracking at +2.60%, ahead of the estimated longer run sustainable level of +1.8%, and in stark contrast to the -0.05% forecast exactly one year ago, when 85% of the economists polled were bracing for a recession. Conversely, the Bloomberg consensus estimates for US CPI were little changed, having started the year at +3.0% and ended it at +3.2%. Putting those forecasts together, we get an expected nominal GDP growth (real GDP growth plus inflation) of +5.8%, the highest annual rate of change since 2005 if we exclude the post-pandemic recovery years (2021 and 2022). The S&P 500 ripped higher in 2023 as high nominal GDP growth supported earnings per share (EPS), which, according to latest analysts' estimates, are expected to grow by roughly +1% for the full calendar year, instead of dropping by -16.4%, the average decline historically recorded during recession years.

For their part, the Chinese economy grew by an annualized +5.2% in Q4 2023, a modest acceleration from the +4.9% recorded in Q3. Rates of change for Q2 and Q1 were +6.3% and 4.5% respectively, which adds up to a GDP growth of +5.2% for the full calendar year, the slowest pace since 1991 if we exclude the two lockdown years of 2020 and of 2022. In other words, not what economists were anticipating, but neither an economic catastrophe. However, incorporating inflation in our analysis indicates that the recovery was more sluggish than what appears at first glance. China has experienced deflation in 7 months out of 12 in 2023, with the domestic CPI declining between -0.1% and -0.5% MoM. At the end of December, the Bloomberg consensus estimates for China CPI for the calendar year 2023 were tracking at +0.4%. Putting this data together, we get an expected nominal GDP growth of +5.6%, that is, a lower rate of nominal growth than that recorded by the US economy over the same period of time. The EPS of the CSI 300, which tracks the performance of the top 300 stocks traded on the Shanghai and the Shenzhen stock exchanges, rose +8%. However, that was not sufficient to prevent the index from sliding for an unprecedented third consecutive year. With EPS rising and prices falling, Chinese stocks cheapened in 2023. Their so-called "risk premium", that is, the difference between their earnings yield and the yield on long-term government bonds, rose to +5.7%, a level only reached 5 times in the last 20 years and associated with strong returns in the 12 months afterwards in all cases.

International Equities

US equities rallied into the end of the year, with the Dow Jones Industrial (+4.84% in USD terms) and the Nasdaq 100 (+5.51%) hitting new all-time highs. The S&P 500 (+4.42% in USD terms) ended the year just -0.56% shy of its all-time high from January 2022. Laggards shone in December with the Russell 2000 recording its 9th best month in history and its 6th largest monthly outperformance ever vis-à-vis the Russell 1000. The popular benchmark for smaller companies had broken below its October 2022 lows just two months before, but at the end of the year it was up +23.87% from that trough. Similarly, the Nasdaq Next Generation 100, which tracks the performance of the largest 100 Nasdaq-listed companies outside of the Nasdaq 100, beat the latter for the first time in 2023. Mega cap growth underperformed the general index as gains for the so-called "Magnificent Seven" group of tech stocks (Apple, Microsoft, Nvidia, Meta (Facebook), Amazon, Alphabet (Google) were more measured. Euphoric retail investors returned to snap up highly speculative stocks, with the Solactive Roundhill Meme Stock Index TR, the GS Non Profitable Tech and the GS Liquid Most Short all up close to or more than +20% in USD terms. The S&P 500 High Beta TR scored a double-digit outperformance vis-à-vis the S&P 500 Low Volatility TR for the first time since January, as traditional defensives such as consumer staples, utilities and healthcare continued to lag. The S&P 500 High Dividend Index TR posted steep gains for the second consecutive month on the back of the strength exhibited by financials, primarily regional banks, which recorded their 6th best month ever, and REITs. Energy was flat in December as oil prices declined for the third consecutive month to their lowest level since June. The VIX Index, the measure which estimates the expected volatility of the S&P 500, fell to its lowest level since September 2018, before the pandemic. US equities slightly underperformed the rest of the world as the Dollar Index (DXY) dropped to its lowest level since March 2022. Europe topped the list for the second consecutive month, and it was the only region to outperform the general index. In Japan, the Nikkei 225 consolidated its recent gains, continuing to hover around its highest level in 33 years despite a strengthening Japanese Yen (JPY). China continued to weigh on emerging markets, as it was the only country together with Turkey to buck the trend during the month. Chinese tech giants dropped and investors rotated into "old economy" stocks within the financial, energy and raw material sectors as the CSI 300's dividend yield surpassed that of long term bonds. All in all, the MSCI AC World Daily TR was up +4.80% in USD terms and +1.27% in AUD terms.

Australian Equities

Australian equities jumped to their highest level in almost two years in December, buoyed by A-REITs, healthcare and miners. The main drivers of performance in each single sector were the largest stocks, namely Goodman Group and Scentre Group, CSL, Cochlear and Sonic Healthcare and BHP Group, Rio Tinto and Fortescue. The latter names benefited from the rising price of iron ore, which gained for the 7th month in a row. The S&P/ASX 300 was up +7.22%, its 7th best month ever and its best performance since November 2020. Strength was widespread across sectors, with the only exception insurance, which ended the month in the red owing to the change that occurred in the rate outlook, with cash futures pricing cuts in 2024. Growth stocks bested value stocks, while mid-caps and smaller companies underperformed the Top 20. Finally, the MSCI Daily TR Net Australia outperformed the MSCI AC World Daily TR by the most since March 2022.

International Fixed Income

On December 13th, the Norges Bank, Norway's central bank, increased the policy rate from 4.25% to 4.50%. It was the only major central bank to harden its monetary policy during the month. On the same day, the FED kept the target rate unchanged at a range of 5.25-5.50% and indicated that it expects 3 rate cuts for a cumulative 75 Bps by the end of 2024. During his press conference, Chairman Powell made a complete U-turn by pivoting dovish. In fact, he admitted that the central bank had already discussed the timing of future monetary easing, while less than two weeks before he had brushed off speculations "on when policy might ease" as "premature". The Bank of England (BOE), the Swiss National Bank (SNB) and the European Central Bank all left interest rates unchanged as well, but remained more cautious on the outlook for rate cuts. Government bonds were lower across the board, with the US 10 year yield ending 2023 at exactly the same level where it started it, that is, at 3.88, while the 2 and 5 year yield dropped roughly 15 Bps over the same period of time to 4.25% and 3.85% respectively. After a rollercoaster ride, the iShares 20+ Year Treasury Bond ETF, a popular benchmark to track the performance of long duration strategies, recovered a YTD loss of -15% in the very last two months of the year, swinging back in the green (+2.77% in USD terms) for 2023. Credit markets extended their rally, with spreads for US Investment Grade bonds tightening below 100 Bps for the first time since January 2021. All in all, the Bloomberg Barclays Global Aggregate Index hedged back to AUD (+3.02%) recorded its 5th best month ever.

Australian Fixed Income

On December 5th, the RBA held the cash rate at 4.35%, delivering its third pause since May. In the accompanying statement, Governor Bullock backed the decision by stating that "the impact of the more recent rate rises, including last month's, will continue to flow through the economy" suggesting that they may work with a lag. The Australian yield curve transposed lower in response, with the 2, 5 and the 10 year yield declining 40 Bps, 44 Bps and 46 Bps to 3.71%, 3.63% and 3.95%. The Bloomberg AusBond Composite 0+ Yr rose +2.69% for the month, while the Australian Dollar strengthened vis-à-vis the US Dollar, ending December above 68 cents.

Real Assets

Global property exploded higher in December, up +10.07% in USD terms and +6.36% in AUD terms. All regions posted positive returns, with Australia topping the list, followed by Europe and the US. Asia lagged as the BOJ left its monetary policy unchanged, prompting Japan to underperform. The FTSE EPRA Nareit Developed TR recorded its 2nd best relative month ever vis-à-vis the S&P Global Infrastructure TR, beating it by the largest amount since March 2009.

Global infrastructure rose +4.74% in USD terms and +1.21% in AUD terms for the month. Renewables and transportation, railroads in particular, performed strongly. Conversely, utilities lagged on the back of the unfavourable regulatory decisions from the Illinois regulator which adversely affected selected US names.

Alternatives

Returns for Alternatives (+1.24%) were mostly positive across strategic mandates in December. Event Driven and Special Situations led the pack, buoyed by the surge in equities and credit, while discretionary macro and CTA and managed futures eked out only small gains.

Market Outlook

Following the collapse of Silicon Valley Bank (SVB) back in March 2023, we argued that the FED would start a differentiated use of its monetary tools going forward, (temporarily) expanding its balance sheet to alleviate the pressure on the banking system, while continuing to increase interest rates to combat inflation. The central bank indeed went on to increase its target rate by another cumulative 75 Bps afterwards, delivering its last hike in July. However, after immediately adding almost 400 Bil USD in assets to quell the regional banks crisis, its balance sheet resumed its trend lower as a result of the quantitative tightening (QT) program letting 95 Bil USD in securities (60 Bil USD in Treasuries and 35 Bil USD in mortgage-backed securities) mature each month. Moreover, the reduction of the FED's balance sheet accelerated from the beginning of June. Since then, it has declined 700 Bil USD to 7.69 trillion USD. However, over the same period of time, the amount of bank reserves, that is, the quantity that QT is designed to drain in the first place, has increased by 189 Bil USD. In other words, in H1 2023 the US banking system remained flush with liquidity despite the central bank actively rolling off its outsized balance sheet. How did it happen? The short answer is, thanks to the increased "coordination" in managing monetary affairs between the FED and the US Treasury.

In fact, as the central bank was not renewing its investment in maturing Treasuries, the US government was replacing those with short term bills to openly entice their purchase by money market funds (MMFs) the reason being, at the end of May, the latter were parking more than 2 trillion USD in cash directly at the FED through the so called Overnight Reverse Repo Facility (ON RRP). The yield provided by that facility is fixed as it is equal to the interest rate that the central bank pays US banks on their reserve balances (IORB) minus 10 Bps, that is, 5.3% at the end of December. As a result, following the suspension of the debt ceiling on June 3rd, 2023, the US Treasury has been purposely issuing bills with an interest rate higher than that offered by the ON RRP, prompting MMFs to withdraw cash from the latter facility to snap up the former instruments. The ON RRP has thus shed 1.5 Trillion USD in H2 2023, falling to

600 Bil USD at the time of writing of this note (January 16th). In summary, the 700 Bil USD reduction which occurred in the balance sheet of the FED has been solely caused by MMFs reallocating their assets from the ON RRP (which is part of the central bank's balance sheet) to bills (which are not), and not by the banks or other investors purchasing Treasuries and draining bank reserves in the process. Cutting through all the technicalities, the gist of it is that in 2023 the QT program was completely sterilized, that is, the FED hardened its monetary stance via higher rates and balance sheet reduction, but the US government more than counteracted the effectiveness of the second tool via the issuance of a deluge of bills.

The above dynamic was perfectly illustrated by Lorie Logan, the President of the Federal Reserve Bank of Dallas, in a speech she gave on January 6th at the annual meetings of the International Banking, Economics and Finance Association (IBEFA) and the American Economic Association (AEA). Speaking about the size of the FED's balance sheet, she observed that "reduced balances in the ON RRP facility have more than offset the decline in securities holdings" as "increased Treasury issuance and a less uncertain interest rate path have contributed to the rapid ON RRP runoff by motivating MMFs to invest more in Treasury bills". No surprises here. What is new is her policy recommendation going forward in which she explicitly called for the subordination of the FED's decisions in relation to the size and the pace of its QT program to the government's financing requirements. She stated that "given the rapid decline of the ON RRP, I think it's appropriate to consider the parameters that will guide a decision to slow the runoff of our assets. In my view, we should slow the pace of runoff as ON RRP balances approach a low level." In plain English, as the ON RRP balances are expected to be completely depleted by the end of Q2 2024, the absorption of "coupons" (or bills) issued by the US Treasury subsequently will act as a drain on bank reserves, that is, the QT program will stop being neutralized and will finally start to reduce the amount of liquidity in the financial system. That would not be a problem in normal circumstances, but the US government has been running an unprecedented amount of spending in 2023, with the US budget deficit hitting -6.46% of GDP at the end of December. In Q4 alone, outlays exceeded revenues by more than 500 Bil USD. To put this number into perspective, before Trump's pro-cyclical tax cuts, COVID-19's cheques and "Bidenomics", 500 Bil USD used to be the budget deficit of an entire, non-recessionary year. And the administration has made it clear that it wants to continue to spend ever more in 2024, with a (divided) Congress currently negotiating an additional, potential deal for 70 Bil USD worth of tax breaks for businesses and families. As a result, we posit that the FED was forced to pivot its stance on rates in December, a decision that will allow the US Treasury to tap the long end of the curve at yields 100 Bps lower than they were at the end of October. Following Ms Logan's remarks, we now expect the central bank to pivot its stance on the balance sheet as well, that is, to end its QT program, and that decision to come before the central bank delivers its first cut.

Futures markets are currently pricing in 6 rate cuts in 2024 with a 86.80% probability with the first cut to be delivered at the FOMC meeting scheduled for March 19-20 with a 73.30% probability. We agree with the quantum of the expected easing (150 Bps), but not with the timing. We see the FED announcing a reduction of the pace of its QT program in March and waiting until May to decrease its target rate by 25 Bps. That may cause bond markets to experience some volatility in the short term, but it does not change the underlying story. The FED has pivoted dovishly and its motive is political. The US government is determined to sustain economic growth via fiscal stimulus in 2024 and the central bank has to abide by it. In a sense, the commitment to the "soft landing" narrative comes from the former. In our opinion, it is not a coincidence that in an interview given to the CNN by Janet Yellen on January 5th, that is, one day before the remarks of Ms Logan, the US Treasury Secretary observed that "what we're seeing now I think we can describe as a soft landing and my hope is that it will continue". She also commented that "Americans are becoming more optimistic" on the back of an economy that "has transitioned to stable and steady growth", a "labour market that continues to fire on all cylinders" and a rate of "inflation that has come way down over the last 6 months". Given the financialization of today's US economy and the fact that the current economic cycle has been primarily driven by income growth rather than credit growth, we think that any easing of financial conditions will tend to flow through to consumers pretty quickly via the so-called "wealth effect". Also, the Atlanta FED wage tracker, a measure of the nominal wage growth of individuals, came in at +5.2% in December for the fourth consecutive month, a number clearly inconsistent with the 2% inflation target. We think that the risk of a second wave of inflation in H2 2024 has increased, but we continue to believe that the continued disinflation prompted by the lagging effect of shelter on inflation in the first half of the year will provide the FED with enough cover to ease its monetary stance.

Putting it all together, we will continue to normalize the duration of our portfolios after having been underweight for the past two years, (ideally) adding to it during bouts of bond weakness. 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 will continue to add to our exposure to global infrastructure and/or 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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