Monthly Market Commentary with Portfolio Manager, Andrea Ciaccio

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Market Review

“2024 is not just an election year. It’s perhaps the election year” is the incipit of a recent article published in Time. 49% of the global population will head to the poll this year as at least 64 countries are expected to hold national elections. Bangladesh, home to 174 million people, broke the ice on January 7th, with the incumbent Prime Minister Sheikh Hasina extending her mandate for a fifth consecutive term. Indonesia and Pakistan, home to a combined 500+ million people, will hold elections in February, followed by Russia (144 million) and Iran (88 million) in March, India (1.4 billion) in April and Mexico (127 million) in June. The possible high-stakes rematch between President Joe Biden and his predecessor Donald Trump in the US (332 million) is scheduled for November. However, one of the most consequential elections of 2024 was held in Taiwan, officially the Republic of China (ROC), on January 13th. Its significance does not lie in sheer numbers, as the country is home to 23.5 million people, but in its disputed political status, as China views the self-governed island as part of its territory under its “One China Principle”. Three candidates ran for the presidency: Lai Ching-Te, chairman of the governing Democratic Progressive Party (DPP), which maintains a pro-independence stance, Hou Yu-Ih, the nominee of the major opposition party Kuomintang (KMT), which is widely regarded as “pro-China”, and Ko Wen-Je, the first and current chairman of the centre-left Taiwan People's Party (TPP), which he established in August 2019 as a “third way” between the two traditional parties.

Two events set the tone for the election. Speaking on the 130th anniversary of Mao Zedong’s birth in Beijing, Xi Jinping, the Chinese president, proclaimed that “our motherland must be reunified, and it will surely be reunified”. His remarks seemed to highlight his determination to fulfil one of the ambitions of the founder of the People's Republic of China (PRC), who wanted to unify Taiwan with the mainland during his lifetime. Then, in the afternoon of January 9th, the text message “Chinese rocket boosted satellite is flying over space of southern Taiwan now” was sent to every mobile phone in Taiwan by the Ministry of National Defence (MND). Four days later, 13.95 million Taiwanese, 71.35% of total qualified voters, a percentage comparable to previous elections, cast their ballots. The ruling DPP party won the presidency for the third consecutive term but lost control of the parliament, with the country returning to a divided government for the first time since 2008. Lai Ching-Te was elected President with 40.05% of the votes, a score that compares poorly with the 57.13% attained by his predecessor Tsai Ing-Wen, but sufficient to beat his rivals, runner up Hou Yu-Ih (33.49%) and Ko Wen-Je (26.46%). However, the DPP lost 10 seats in the parliament, while the KMT and the TPP gained 14 and 3 seats respectively. As a result, the KMT became the largest single party with 52 seats, followed by the DPP with 51 and the TPP with 8. Several analysts have attributed the lacklustre performance of the DPP to young voters disappointed with inadequate wage adjustments during the inflationary post-pandemic years and the party’s perceived inability to deal with skyrocketing housing prices. This is in stark contrast with the DPP’s emphasis on Taiwan’s superior economic achievements since 2020, a period in which the country recorded the highest rate of growth among the so-called “Four Little Dragons” of Asia (with the other three being Hong Kong, Singapore and South Korea). In other words, young voters, while remaining vary of Beijing’s authoritarian system, may be becoming more concerned about domestic economic issues rather than geopolitical issues.

China’s initial reaction has been diplomatic and economic in nature rather than military. Beijing has immediately moved to restore relations with the Republic of Nauru, one of the only 13 nations that still maintain diplomatic relationships with Taiwan, with the aim of convincing the government of the tiny island country to shift its recognition from Taiwan to China. Beijing is also looking to terminate the Economic Cooperation Framework Agreement (ECFA), a treaty signed in 2010 that offers zero tariff for hundreds of Taiwan’s agricultural, aquatic, and petrochemical products. China is Taiwan's top trading partner, as 35.25% of its exports were shipped to the mainland in 2023. However, this number has steadily declined in the last 20 years, and a rescission of some or all of the preferential tax rates for Taiwanese products will affect only an estimated 8% of Taiwan’s total exports.
In summary, the outcome of the Taiwanese elections appears to be a continuation of the status quo and may usher in a lowering, rather than a heightening, of the level of tension across the strait. The presidency will be retained by the DPP, which has held it for the past eight years, while a divided parliament may result in a more balanced approach to international relations.

International Equities

US equities extended their winning streak to three consecutive months in January, as the Dow Jones Industrial (+1.22% in USD terms), the S&P 500 (+1.59%) and the Nasdaq 100 (+1.85%) all hit new all-time highs. The persistency of the rally since late October 2023, when all three major indices bottomed simultaneously, may be suggestive of a rally driven to a certain extent by the so-called “Fear Of Missing Out” (FOMO). In fact, at the end of January, the S&P 500 had finished 12 of the last 13 weeks higher, a historically rare phenomenon which has happened on only 29 occasions over the last 73+ years, and last occurred almost 40 years ago. However, multiple divergences emerged under the surface as, once again, the largest companies recorded the strongest gains. Mega cap growth outperformed the general index despite the so-called “Magnificent Seven” group of tech stocks acting more like “Magnificent Four”, that is Microsoft, Nvidia, Meta (Facebook) and Amazon, as Alphabet (Google) lagged, Apple bucked the trend and Tesla cratered. The Russell 2000, the popular benchmark for smaller companies, fell hard despite Super Micro Computer Inc., an Artificial Intelligence (AI) play and its largest constituent, almost doubling in value during the month. As a result, the index recorded its 12th largest monthly underperformance ever vis-à-vis the Russell 1000, weighing on the S&P 500 Equal Weight Index (-0.91%). The S&P 500 High Beta TR underperformed the S&P 500 Low Volatility TR while the S&P 500 High Dividend Index TR gave back part of the double-digit gains generated in the previous two months as REITs and regional banks sank. Communication services, financials, healthcare and technology were the best performing sectors, while consumer discretionary, materials, utilities, industrials and energy ended the month in the red. The VIX Index, the measure which estimates the expected volatility of the S&P 500, rose together with US equities for the first time since May 2023.

US equities strongly outperformed the rest of the world as the MSCI AC World Index ex USA TR Index was down for the month. Japan topped the list, with the Nikkei 255 resuming its ascent and breaking past the 35,000 mark for the first time since February 1990. In Europe, Novo Nordisk, the Danish manufacturer of obesity and diabetes drugs Wegovy and Ozempic, breached above the 500 Bil market cap, cementing its position as the most valuable company in the region. Emerging markets were dragged lower by China, where a cascade of liquidations was prompted by the so-called “snowballs”, highly popular structured derivatives offered by the nation’s largest brokers, hitting the triggers for “knock-in”. Only India, Turkey and Argentina stood their ground in a sea of red. All in all, the MSCI AC World Daily TR was up +0.59% in USD terms and +4.24% in AUD terms.

Australian Equities

Australian equities were down for the better part of January, shedding more than -3% at one point, however, 8 days in a row in the black prompted the market to swing back into positive territory for the month. Not only that, but on January 31st the S&P/ASX 200 closed at a new all-time high, surpassing its previous peak recorded in August 2021. The S&P/ASX 300 was up +1.10%, led higher by energy, financials, primarily the big four banks and insurance, healthcare, industrials and consumer discretionary. Materials were the worst performing sectors, as miners dropped on the back of lower iron ore prices and pessimism about the economic outlook for China. Gold and lithium producers were also under pressure. The Top 20 strongly outperformed smaller companies and mid-caps, with the latter group posting losses for the month. Finally, the MSCI Daily TR Net Australia underperformed the MSCI AC World Daily TR by the most since May 2023.

International Fixed Income

Every major global central bank that met during the month left interest rates unchanged. Those include the FED, the European Central Bank (ECB), the Bank of Japan (BOJ), the Bank of Canada (BOC) and the Norges Bank, Norway’s central bank. On January 25th, the FED raised the rate on loans issued under the Bank Term Funding Program (BTFP), an emergency facility launched in March 2023 at the height of the regional banking crisis that allows banks and credit unions to pledge US Treasuries and agency as collateral at par in exchange for cash. Before the central bank’s decision, those advances were granted at the 1 year overnight index swap (OIS) rate plus 10 Bps. However, in the last two months that rate had fallen below 5% on expectations of rate cuts, creating an arbitrage opportunity for the banks. In fact, the latter were tapping the BTFP and then parking the proceeds in their accounts at the FED to earn the interest on reserve balances (IORB), currently at 5.40%. The central bank has also announced that the BTFP will cease making new loans on March 11th. 5 of the 12 central banks across major emerging market economies that met during the month cut rates. Brazil, Hungary, Colombia and Chile extended their easing cycle, while Israel (which in recent years has attained the status of developed country) lowered its short-term borrowing rates for the first time since February 2020, from 4.75% to 4.50%. Conversely, the Central Bank of the Republic of Turkey (CBRT) delivered another steep hike (+250 Bps) to combat an entrenched inflation and a weakening currency. Government bonds were a mixed bag, with short term yields falling and long term yields rising in US, while the entire yield curve transposed higher and “bear steepened” in Europe. Credit spreads were mostly unchanged, while emerging markets sold off as investors took profit following a year of double-digit returns. The Bloomberg Barclays Global Aggregate Index hedged back to AUD was down -0.31% for the month.

Australian Fixed Income

Australian consumer price inflation rose +0.6% QoQ and +4.1% YoY in Q4 2023, missing expectations of +0.8% and +4.3% respectively. In addition, retail sales slid -2.7% on a seasonally adjusted basis in December, a larger decline than that forecasted by analysts. As a result, the cash futures moved to price in two rate cuts (from one) in 2024. The Australian yield curve steepened modestly, with the 2 and 5 year yield declining 3 Bps and 2 Bps to 3.68% and 3.61% respectively, while the 10 year yield added 6 Bps to 4.01%. The Bloomberg AusBond Composite 0+ Yr was up +0.21% for the month, while the Australian Dollar softened vis-à-vis the US Dollar, ending January below 66 cents.

Real Assets

Global property dropped -4.40% in USD terms and -0.92% in AUD terms in January. Australia was the only market to post gains when measured in the domestic currency. On January 29th, a Hong Kong court ordered the liquidation of China Evergrande Group, the world’s most-indebted property developer. Global infrastructure declined -3.58% in USD terms and -0.08% in AUD terms for the month. Renewables and telecom infrastructure were adversely affected by pared rate cut expectations. Conversely, selected toll roads and airports performed strongly on the back of increased tariffs.

Alternatives

Returns for Alternatives (+0.21%) were mostly subdued across strategic mandates in January. Long/Short equities managers and CTA and managed futures eked out gains, while discretionary macro and Event Driven ended the month in the red.

Market Outlook

The German economy stagnated in 2023, with GDP shrinking by -0.3% on the year. The euro zone narrowly avoided a first, minor recession since the pandemic as its economy grew by +0.1% in Q4, recovering from a decline of -0.1% in Q3. Spain ended the year on a high note, offsetting the malaise in Germany, however, according to a first estimate, annual growth for the euro zone in 2023 was a meagre +0.5%. UK and Japan unexpectedly slipped into a so-called “technical recession” in H2 2023 as both countries recorded two back-to-back quarters of negative GDP growth, -0.1% in Q3 and -0.3% in Q4 for the former, -0.8% in Q3 and -0.1% in Q4 for the latter. On a yearly basis, Japan performed better, growing by +1.9% YoY. Conversely, British GDP is projected to have risen by just +0.1% last year, the lowest increase since 2009 if 2020, the year of the first COVID-19 lockdowns, is excluded. Finally, China’s economic performance in 2023 was lacklustre, as the eagerly anticipated reopening boom failed to materialize. The country recorded 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 2022, and experienced persistent deflation. In summary, while the US economy remained resilient in 2023, increasing by +3.1% YoY on the back of unprecedented fiscal stimulus and increased “coordination” in managing monetary affairs between the FED and the US Treasury, growth in the Rest of the World was disappointing. That divergence in economic performance was, in our opinion, reflexive, that is, sluggish growth outside of the US forced escalating commodity prices lower, helping the FED combat domestic inflation. In fact, the Bloomberg Commodity Index fell -12.55% in 2023, following 2 consecutive years of strong gains (+27.05% in 2021 and +13.75% in 2022). In turn, the softening of the rate of CPI increase that occurred during the year (from +6.5% to +3.4% YoY in 12 months), reinflated the purchasing power of American consumers, already buoyed by superior nominal wage growth, and supported their spending. The US Dollar remained well bid for the most part of the year as capital continued to flow into the country from all over the world owing to the American economic and stock market “exceptionalism”. The Dollar Index (DXY) ended 2023 roughly -2% lower than it was at the beginning of the year, preventing an upturn in import prices.

We do not think that the trend described above will sustain itself in H1 2024. Growth in the euro zone may have bottomed and it appears poised to accelerate in the following months (admittedly from a low basis), particularly so if the European Central Bank (ECB) delivers the 4 rate cuts currently priced in the yield curve. In Japan, the prospects of the first rate hike since 2007 on the part of the BOJ are becoming more remote, with the result that monetary policy may remain ultra-loose. China has yet to unleash the “bazooka”, but it has been progressively ramping up stimulus measures to stabilize its stock market and shore up the beleaguered housing sector. Despite the long term structural headwinds, the country is expected to enter a cyclical recovery in the first half of 2024 that could reignite confidence in consumers and investors. In addition, the inflation backdrop in the US has gotten more complicated following the release of the CPI report for January 2024, which saw almost all relevant measures surprise on the upside. First, the headline number came in hotter than anticipated, rising +0.3% MoM and +3.1% YoY against expectations of +0.2% MoM and +2.9% YoY. The US CPI Core, which excludes the more volatile food and energy components, grew +0.4% MoM and held steady at +3.9% YoY. More worryingly, the so-called “Super Core CPI”, which is designed to provide a better representation of service inflation by stripping away the shelter component, was up a shocking +0.85% MoM, its highest rate of change since April 2022. Finally, the Bank of Cleveland 16 Trimmed-Mean CPI and Atlanta Fed Sticky CPI Monthly rose +0.47% and +0.54% MoM, the most since September 2022 and February 2023 respectively. In our opinion, it is too early to tell whether those numbers signal an imminent inversion of the disinflationary trend that occurred in the previous 18 months, or if they are just statistical noise around a central, descending tendency. At present, we deem that a “second wave” of inflation is unlikely to emerge in the foreseeable future, and we think that the FED will not be deterred from cutting interest rates in 2024. That said, our view has always been that the “last lag” of the disinflation process, that is, getting from +3% to +2%, would prove exceedingly difficult for the central bank to navigate in the absence of a recession. Even if the FED managed to pull off such a feat, inflation won’t linger there for a sustained period of time, as in the new world of “fiscal dominance” the +2% threshold is likely to act as a floor rather than a ceiling for US CPI.

Futures markets are currently pricing in 4 rate cuts in 2024 with a 60.20% probability with the first cut to be delivered at the FOMC meeting scheduled for June 11-12 with a 78% probability. In that context, government bond valuations appear fair to us as the underlying story has not changed: the FED has pivoted dovish and will proactively ease to engineer a “soft landing” for the US economy. For that reason, 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. Active managers are to be preferred at this juncture to attain a fixed income exposure characterized by a duration comparable to that of the benchmark in aggregate but tilted towards specific parts of the curve. Currently we think that the short end (2-3 years) and the very long end (10 years or greater) are more attractive than the belly (anything in between), as we think that the FED could potentially cut more than what is currently priced in and that the risk of the US economy entering a recession remains elevated. On the equity side, we think that the positive momentum 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. The US cycle has been artificially prolonged by excessive deficit spending and (stealth) liquidity provision, but it is starting to exhibit signs of fatigue. Advance retail sales declined -0.8% in January, potentially signalling that consumers may have reached the point where they cannot continue to absorb price increases without curtailing their shopping. The so-called “control group” of retail sales, which excludes food services, autos, gasoline and building materials and are used to calculate GDP, fell for the first time since March 2023, down -0.4%. For its part, corporate America is on track to deliver a modest +2/+3% increase in earnings per share (EPS) for the entire 2023, below the rate of inflation and less than half the rate of nominal GDP growth. Those factors, coupled with an extreme long positioning in US equities and rich valuations, compel us to look for more attractive opportunities elsewhere, however, the so-called “FED put” is operative again, and that should cushion any potential drawdown should volatility pick up going into spring. Finally, we maintain a positive stance on real assets and we will continue to add to our exposure in global infrastructure and/or global property, subject to the various risk constraints of each model portfolio.

AZ Sestante

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E: invest@azsestante.com | www.azsestante.com

Important information

The Morningstar Historical Corporate Sustainability Score is a weighted average of the trailing 12 months of Morningstar Portfolio Corporate Sustainability Scores. Historical portfolio scores are not equal-weighted; rather, more-recent portfolios are weighted more heavily than older portfolios. Combining the trailing 12 months of portfolio scores adds consistency while still reflecting portfolio managers' current decisions by weighting the most recent portfolio scores more heavily.

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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