Monthly Market Commentary with Portfolio Manager, Andrea Ciaccio

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Market Review

In the early Asian hours of April 29th the Japanese Yen (JPY) weakened past the 160 level vis-à-vis the US Dollar (USD) for the first time since April 1990 then surged back to 154.55 in the afternoon, an intraday appreciation of +3.51% highly suggestive of an intervention by the Minister of Finance (MoF) in the foreign exchange (FX) market (a higher value of the cross equates to a stronger USD and a weaker JPY). Market analysts estimate that in order to bolster the value of the floundering domestic currency, the government had to spend 5 Trillion JPY, equivalent to more than 30 Bil USD. Japanese officials refrained from confirming the intervention, however, the exact amount of it (if any) will be disclosed at the end of May. Between September and October 2022 the MoF spent 9.2 Trillion JPY, equivalent to around 62 Bil, in three separate interventions. Back then, the value of the domestic currency had fallen to 150 vis-à-vis the greenback, a level that was considered the "Maginot line" at that time. Spooked traders reduced their shorts on the currency pair and that, coupled with the emergence of FED rate cut expectations in the back end of 2023, bolstered the value of the JPY temporarily. However, a more resilient US economy and stickier inflation prompted the US central bank to adopt a "higher for longer" stance. As a result, the JPY resumed its slide, dropping from around 130 to 160, a -20% depreciation in the space of 12 months. Before 2022, the last time Japan had to intervene in the FX market to support the JPY was between April and June 1998, during the Asian financial crisis. From 1999 to 2011, the MoF had to intervene multiple times to curb excessive gains, not losses, in the value of the currency.

The issue faced by Japan today is that its central bank ended decades of so-called "Zero Interest Rate Policy" (ZIRP) only in March of this year, when it raised the overnight lending rate by 10 Bps to a range of 0%-0.1%. In contrast, the FED administered the first hike of the current tightening cycle in March 2022, and, at the end of April, its target rate was 525 Bps higher than it was 2 years before. With the Bank of Japan (BOJ) stuck in an ultra-loose monetary policy the whole time, the JPY has experienced a sharp devaluation on the back of a widening interest rate differential. In that context, MoF's interventions are (unofficially) aimed at buying time until the FED reverses its course of action, however, rate cuts have been repeatedly priced out and postponed, every time putting renewed pressure on the JPY. It is speculated that the MoF used cash reserves to fund its intervention, but according to Bank of America, it will likely have to tap its holdings of US Treasuries next time. Japan is the world's largest foreign holder of US Treasuries, and the risk is that it may be caught in a vicious spiral in which it is forced to sell those to prop up its domestic currency, but in doing so it contributes to rising US yields, in turn causing further depreciation of the JPY.

According to several market analysts, a persistently weaker JPY may also have spillover effects on Asian currencies, and in the worst case scenario lead to a one-off devaluation of the Chinese Renminbi (RMB). In fact, China and Japan are two export powerhouses, and the cheapening of the JPY is helping the latter regain competitiveness to the detriment of the former. The RMB is not fully convertible and its value is kept in a range against a basket of currencies by the People's Bank of China (PBOC). The US Dollar is the largest constituent in the basket at 19.46% and remains predominant in the determination of the value of the RMB. Every day, the China Foreign Exchange Trade System (CFETS) publishes the so-called "central parity rate" of the Chinese currency vis-à-vis the greenback. The USD/RMB pair is then allowed to fluctuate around the new fixing within a 2% trading band. When traders are bearish on the currency, they push it away from the central parity and closer to the upper band (a higher value of the cross equates to a stronger USD and a weaker RMB). If in the following days the fixing does not adjust accordingly, the cross eventually reaches the upper band and flatlines, with the exchange rate becoming de facto fixed. That is exactly what happened between March and August 2015, just before the PBOC surprised the market with a -3% devaluation of the RMB. Back then, the Chinese currency was coming from a decade of constant strengthening vis-à-vis the USD, while today its value is roughly -16% lower than it was at its peak. However, yields in China are 200-300 Bps inferior to those in the US across the curve, and the selling pressure on the JPY does not seem to be relenting any time soon. As a result, the USD/RMB pair has been trading very close to its upper band for the past three months.

International Equities

US equities declined in April, with the Dow Jones Industrial (-5.00% in USD terms), the S&P 500 (-4.16% in USD terms) and the Nasdaq 100 (-4.46%) breaking a five-month winning streak. The "Magnificent Seven" group of tech stocks outperformed the general index as Alphabet (Google) jumped on results that exceeded consensus expectations. In addition, it authorized its first-ever dividend together with a new 70 Bil USD buyback. Tesla caught a bid despite missing earnings estimates on both revenues and earnings for the third consecutive quarter. Amazon and Apple curbed losses. Utilities was the only sector to end the month in the black. Energy, consumer staples and industrials outperformed the general index, while real estate, technology and healthcare lagged. The torrid rally in semiconductor stocks paused as Nvidia gave back part of its recent gains. The Russell 2000, the popular benchmark for smaller companies, dropped the most since September 2022 and underperformed the Russell 1000. Risk appetite waned, prompting the S&P 500 Low Volatility TR to beat the S&P 500 High Beta TR by the most since October 2023. Between March 28th and April 19th, the S&P 500 completed its first correction greater than -5% in 2024. US equities lagged the general index and underperformed the rest of the world (as exemplified by the MSCI AC World Index ex USA TR Index) by the most since October 2022. Emerging markets posted gains on the back of the continuous resurgence of the Chinese stock market. Sentiment improved as China's GDP grew +5.3% YoY in Q1 2024, well above market expectations of +4.8%. Mainland investors increased their exposure to the so called "H-Shares", Chinese companies listed in Hong Kong, to a record high to capitalize on the rally of the Big Tech names listed there. India and Mexico continued to exhibit positive momentum, while South Korea and Taiwan fell. Japan was the worst performing region on profit taking and a softening currency. All in all, the MSCI AC World Daily TR was down -3.30% in USD terms and -2.79% in AUD terms.

Australian Equities

Australian equities fell from the fresh all-time highs achieved at the end of March, ending the month with steep losses. The S&P/ASX 300 was down -2.94%, led lower by A-REITs, consumer discretionary, telecommunication services and energy. Utilities posted strong gains in line with their global peers. Resources bucked the trend on the back of further increases in the price of copper (+13.91%) and gold (+2.91%). In addition, iron ore rose double-digits, interrupting a three month losing streak. On April 25th, BHP Group made an all-share takeover offer to acquire Anglo American which valued the smaller rival close to 60 Bil AUD, that is, roughly +15% higher than its closing price. A tie-up between the two companies would create the largest copper producer in the world, controlling 10% of global output. However, one day later, Anglo American rejected the bid stating that it “significantly undervalues” the target. Mid-caps outperformed the Top 20, while smaller companies lagged. Finally, value stocks bested growth stocks for the third consecutive month.

International Fixed Income

Every major global central bank that met during the month left interest rates unchanged including the Bank of Japan (BOJ), the Bank of Canada (BOC), the Reserve Bank of New Zealand (RBNZ) and the European Central Bank (ECB). Christine Lagarde, President of the latter, reiterated that June may be an appropriate time to ease monetary policy conditions. Cracks started to emerge in emerging markets as the strength of the US Dollar spurred by expectations that the FED may delay cutting rates forced selected countries to recalibrate their monetary policy. Bank Indonesia hiked its benchmark seven-day reverse repo rate by 25 basis points to 6.25% in a surprise move aimed at shoring up a sliding Rupiah (IDR). US GDP grew +0.4% QoQ and +3.0% YoY in Q1 2024, missing market estimates for a more robust increase. Conversely, the US CPI for March accelerated to +0.4% MoM, taking annual headline inflation to +3.5% YoY, while the so-called US CPI Core, which excludes the more volatile food and energy components, remained elevated at +3.8% YoY. Those numbers were interpreted as early symptoms of a developing stagflationary condition, leading to a sell-off in global bond markets. In the US, the yield curve transposed higher as the 10 year yield spiked by the most since September 2022, briefly breaching above 4.70%. Credit spreads were generally tighter during the month despite rising rates and faltering equity markets. The Bloomberg Barclays Global Aggregate Index hedged back to AUD (-1.70%) fell for the 3rd month out of the last 4, extending its losses since the beginning of the year to -2.01%.

Australian Fixed Income

Domestic macroeconomic data was mixed in April. On the one hand, the headline unemployment rate increased slightly to 3.8% in March, although employers responded to softness in demand by shedding primarily part-time roles. On the other hand, Australia’s quarterly CPI rose +1% QoQ and +3.6% YoY for the first three months of the year, topping expectations of +0.8% and +3.5% respectively. The Australian yield curve bear steepened, with the 2, 5 and 10 year yield rising 34 Bps, 49 Bps and 46 Bps to 4.10%, 4.10% and 4.42% respectively. The Bloomberg AusBond Composite 0+ Yr dropped -1.98% for the month, moving into negative territory since the beginning of the year. The Australian Dollar strengthened vis-à-vis European currencies, held steady against emerging currencies and weakened vis-à-vis the greenback.

Real Assets

Global property cratered -6.02% in USD terms and -5.53% in AUD terms in April. Europe and Asia outperformed the general index. Hong Kong was the best performing market as investors snapped-up cheaply valued, high dividend paying stocks in the battered city-state. Conversely, Australia and US underperformed the benchmark on renewed uncertainties about the future path of rate cuts.

Global infrastructure declined -0.62% in USD terms and -0.10% in AUD terms for the month. Telecom infrastructure and transportation continued to exhibit weakness. Conversely, utilities (electric, gas and water) outperformed as the power generation industry took center stage in the Artificial Intelligence (AI) boom given the massive amount of energy required for computation and data storage. The S&P Global Infrastructure TR recorded its 9th best relative month ever vis-à-vis the FTSE EPRA Nareit Developed TR, beating it by the largest amount since March 2023.

Alternatives

Alternatives (-0.65%) strongly outperformed global equities in April. Long/Short equities managers curbed losses, while discretionary macro and CTA and managed futures ended the month in the black as they benefited from the volatility generated by increased geopolitical risk.

Market Outlook

The fear of the FED "pivoting the pivot" by reinstating a hawkish tone dissipated following the FOMC decision and Chairman Powell's press conference on May 1st. First, the central bank confirmed that, starting in June, it will more than halve the pace of the decline in its Treasury securities portfolio from 60 Bil USD to 25 Bil USD per month. In plain English, every month an additional 35 Bil USD in principal payments from maturing Treasuries will be reinvested by the FED in newly auctioned securities, with the latter not having to be soaked up by the bond market. Second, Chairman Powell took rate hikes off the table, clarifying that the central bank's reaction function remains firmly asymmetric and that its focus is on the duration of time it will have to keep the monetary policy restrictive. The FED will cut rates once it gains "greater confidence that inflation is moving sustainably toward 2%" and, until that time, it will limit itself to hold rates at current (elevated) levels. As such, any adverse inflation data can only delay, but not derail, the expected easing to come. Finally, asked about the recent lack of progress on the inflation front, Chairman Powell explained that, because only a minority of rents roll-over each year, the surge in the so-called "market rents", that is, rents on newly signed leases, recorded in 2021 and 2022 is still working its way through the system, however, he reiterated his conviction that the long-awaited disinflation in shelter will eventually materialize, and that only its timing remains uncertain. In summary, the FED is dovish and wants to cut rates in 2024. Its resolve to ease monetary policy is understandable in our view as, historically, a proactive central bank has been the critical factor required to achieve a "soft landing" of the US economy. As a comparison, in 1995, Chairman Greenspan delivered the last hike in February and the first cut in July, that is, only 5 months later. Fast-forward to today, 8 months have already passed since the FED increased its target rate by 25 Bps for the final time to a range of 5.25%-5.50%.

The clock is clearly ticking and the central bank may be starting to be concerned about the "long and variable lags" of holding interest rates higher for longer. In addition, we have posited for almost a year now that the massive fiscal largesse resulting from "Bidenomics" compels increased "coordination" in managing monetary affairs between the US Treasury and the FED. Hence, it is plausible that the latter may be looking to lessen the burden on public finance by lowering the cost to service the exploding government debt. In fact, in the first 7 months of the fiscal year 2024, that is, from October 2023 to April 2024, the US government has spent 514 Bil USD on net interest, which equates to 13.5% of its total outlays and 60% of the budget deficit recorded over the same period of time. Moreover, the marketable debt supply of Treasuries expected in the next 12 months is close to 11 Trillion USD, an all-time high. We may have reached the point whereby the (stealth) fiscal stimulus has become an issue for the FED and also a liability for the economy. In an interview with Market News, former Dallas FED President Robert Kaplan has argued that one of the reasons why the FED has been unable to cut rates thus far is "excessive government spending" leading to sticky inflation, particularly in the services sector. He correctly noted that "monetary policy is highly restrictive, however, fiscal policy is historically stimulative" and that the implementation of packages the likes of the Bipartisan Infrastructure Law and the Inflation Reduction Act (IRA) is happening "pre-recession", which is unusual, thus exacting a heavy price in terms of higher interest rates. "We are buying this soft landing" was his conclusion, and we concur. Last year, in its eagerness to keep the economy hot, the US government de-facto neutralized the tightening administered by the FED. However, the "monetary handover" from the latter to the former, as an astute commentator termed it, has now backfired as it is preventing the central bank from cutting rates. As a result, the government may have bought a "soft landing" in the short term, but that outcome will not last if the FED is not able to secure it with an easing of its monetary policy.

The deteriorating macroeconomic data that has come out in the last few weeks points in that direction. At the time of writing of this note (May 21st), the Citi Economic Surprise Index for US has dropped to its lowest level since January 2023, signalling that the US economy may be entering a soft patch. In that context, the FED may want to act sooner rather than later and pre-emptively deliver one or more "insurance cuts" to mitigate the downside risks to growth and employment. However, for the central bank to actually deliver on its easing promises the government has to implement a more hawkish fiscal policy, at least at the margin. US Treasury Secretary Yellen appears to have gotten the memo as the preliminary Quarterly Refunding Announcement ("QRA") released on April 30th projected 847 Bil USD of new issuances for Q3 2024, a massive increase from the 243 Bil USD of government debt planned for the current quarter. In addition, the funding composition is expected to undergo a significant adjustment, with the share of bills declining to 34% and the share of "coupons" increasing to 66%, respectively the lowest and the highest value since Q1 2023. Said differently, in the next few months the bond market will have to absorb an enormous amount of government bonds that carries interest rate risk. It seems that the US Treasury is deliberately looking to tap the long end of the curve in size rather than concentrating on short term financial instruments that are more likely to be scooped up by a variety of domestic (money market funds) and foreign (sovereign entities) investors. In our opinion, Janet Yellen is signalling that she intends to tighten financial conditions by putting upwards pressures on yields, essentially reversing the stance she adopted in 2023. Such change will tend to flow through to consumers pretty quickly via the so-called "wealth effect", with potentially positive repercussions on inflation. In summary, we think that the US Treasury is pivoting hawkish to provide the FED with the necessary leeway to inaugurate its easing cycle in the second half of the year.

Putting it all together, we expect US yields to be range bound going forward, with the long end of the curve caught in a tug of war between increased supply and a slowing economy. However, if the latter happens fast enough, even just temporarily, rates may move lower pretty quickly on the back of the additional tailwind provided by rate cuts. As a result, we will continue to add duration during bouts of bond weakness. We favour active managers 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. In such a scenario, the bias should be for a stable or softening US Dollar, which should favour a continuation of the nascent economic recovery in the Rest of the World (RoW). For that

reason, we think that the positive momentum in stock markets may persist during summertime (in the Northern Hemisphere), with a broadening of the rally from mega caps growth. Equity investors may have to endure some volatility in the short term, but the so-called “FED put” is operative again. We are looking for the extreme long positioning in US equities to gradually unwind and for capital to flow back into biggest laggards of 2023, primarily emerging markets and interest rates sensitive sectors.

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

Important information

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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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