Monthly Market Commentary with Portfolio Manager, Andrea Ciaccio

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Market Review

The price of copper has long been considered a leading indicator of global growth given that the red metal is widely used in housing, construction and electrical engineering. Its ability to predict the macroeconomic outlook earned it the title of "Dr. Copper". However, a recent history of misdiagnosis may indicate that the time has come to revoke such an honorary PhD. In fact, back at the beginning of February, copper was languishing at around the same level it was in June 2022, that is, at a time when the US economy was going through its second consecutive quarter of contraction. Then, in a little less than 3 months, it jumped almost +25%. It then went on to rise an additional +12.15% in the first three weeks of May, hitting a new all-time high in the process, before crashing -9.65% during the back end of the month. After a rollercoaster ride, copper was up +0.82% in May and +19.37% since the beginning of the year. The steep rally does not seem to be coinciding with any discernible acceleration in economic activity. If anything, the US economy has been flashing signs of an impending slowdown lately, with GDP growth for Q1 2024 revised lower, from +0.4% to +0.3% QoQ, its lowest level since Q2 2022, on the back of weaker consumption spending.

It is speculated that the rally in copper prices may be related to the latest support package announced by the Chinese government to revive its beleaguered property market. On May 17th, the People's Bank of China (PBOC) abolished the mortgage floor rate nationwide and cut the minimum down-payment ratio to 15% for first-time buyers and to 25% for second homes, from 20% and 30% respectively. In addition, the central bank is establishing a 300 Bil RMB (equivalent to around 42 Bil USD) relending facility that local governments of regions where there are relatively large commercial housing stocks will be allowed to tap to acquire some homes at "reasonable" prices and provide them as affordable housing. The announced measures are the most forceful to date, yet they are not expected to significantly move the needle in terms of GDP growth. Hence, according to several market analysts, the rising price of copper may no longer be due to cyclical reasons. Instead, it may be caused by a perfect storm of booming demand connected to electrification, transportation and Artificial Intelligence (AI) bumping up against a looming shortage of supply.

Copper has emerged as the indispensable industrial metal in the green energy transition. It has been touted as "the new oil" despite the fact that 60% of all copper is recycled, meeting 30% of market needs every year. Between 2012 and 2022, its use in power utility (modernization of the grid), automotive (electric vehicles) and cooling equipment (data centres) has grown +60.94%, +32.50% and +30.43% respectively. According to the International Energy Association (IEA), in order to reach the net-zero emissions target by 2050, the global demand for copper may have to grow by +51% between 2023 and 2040. Copper is used 2.5 to 7 times more in renewable energy systems than in fossil fuel and nuclear based technologies, with wind turbines and solar photovoltaic panels having the highest copper content of all. In 2023 alone, China, which accounts for over 50% of the global copper demand, installed 14% of the world's total solar capacity to date. The country has been the biggest generator of renewable energy since 2021. Electric vehicles (EV) can use as much as 80kg of copper, that is, almost 4 times the total amount contained in internal combustion engine (ICE) passenger cars and in 2022 they accounted for two-thirds of the global demand growth in copper. Finally, AI-ready racks utilize energy intensive Graphics Processing Units (GPUs) and require 4 to 6 times more power and cooling compared to traditional racks. As a result, in the next 5 years 0.5%-1.5% of global copper demand may come from the buildout of data centres alone.

Copper is plentiful, but developing a new mine is lengthy and expensive, with the entire process from discovery to production taking 16.5 years on average. Codelco, owned by the Chilean government, is the world's largest copper supplier, however, in 2022 its production slumped to its lowest level in 25 years, and in 2023 it suffered a further -8.4% decline as the state-owned company struggled with the development of new projects and improving operational efficiency. According to Bloomberg Intelligence, BHP Group is poised to take the lead in 2024 following its acquisition of copper producer OZ Minerals. The Australian giant made an all-share bid for its smaller rival Anglo American in April. The transaction would have given it control of 10% of the red metal's global output, but the offer was rejected. In general, the industry appears to be more eager to add reserves and production via M&A rather than to invest in exploration and new capacity. As a result, capital expenditure has risen far less than in previous cycles and it remains well below pre-pandemic levels. Copper exchange inventories have recently reached historic lows, increasing the risk of abrupt price spikes. Since the end of 2023, the copper's curve has been in backwardation, with short-term contracts higher than those further in the future, suggesting supply constraints. Speculative buying has risen in the past few months and option contracts continue to exhibit a positive skew despite the recent volatility. However, as compelling as the new "copper supercycle" thesis may be, it seems unlikely that in the short run prices can escape the old-fashioned "boom-busts" dynamic typically associated with commodities investing.

International Equities

US equities rose in May, with the Dow Jones Industrial (+2.30% in USD terms), the S&P 500 (+4.80%) and the Nasdaq 100 (+6.28%) all hitting new all-time highs. Utilities was the best performing sector for the second month in a row, followed by technology, communication services and real estate. All other groups lagged the general index as the breadth of the market rally narrowed to multi-year lows, while energy ended the month in the red amid weaker oil prices. On May 23rd, Nvidia delivered another blowout earnings report which saw revenues and net income rising by +268% and +628% YoY respectively. The stock jumped +9.32% following the news, while the broader market fell as only 54 components of the S&P 500 ended in positive territory. As a result, for the first time in its history, the most popular benchmark for US equities declined on a day when one of its top constituents, that is, larger than 3%, added more than +9%. Nvidia was up +26.89% for the month and +121.39% for the first 5 months of the year. Its weight increased to 6.11% from 5.0% at the end of April and from 3.05% at the end of December 2023. Since the beginning of the year, the chip giant has contributed close to 4.0% to the +11.30% performance of the S&P 500, that is, roughly 33% of the general index's total return, becoming the highest impactful single stock ever. At the end of May, the Dow Jones Industrial was lagging the S&P 500 by almost 8% over the same period, with half of that underperformance attributable to the absence of Nvidia in the former, more concentrated index.

US equities outperformed the rest of the world (as exemplified by the MSCI AC World Index ex USA TR Index) in May. Europe was the best performing region on the back of improving business activity and wages growing at the fastest pace in nearly a decade in Germany. Japan and emerging markets eked out gains in local currency but were down in AUD terms. All in all, the MSCI AC World Daily TR was up +4.06% in USD terms and +1.66% in AUD terms.

Australian Equities

Australian equities could not keep up with their international peers in May, with the S&P/ASX 300 rising by a more modest +0.85%. Technology was the best performing sector on the back of positive earnings momentum. Xero reported its FY 2024 results which showed substantial improvements in key operating metrics, with the company delivering on its commitment to balance growth with profitability. In particular, Xero recorded an impressive +52% YoY growth in operating cash flow, while diluted earnings per share swung to profit. Banks and utilities posted strong gains, while A-REITs bounced back as Goodman Group returned to and exceeded its previous all-time highs on improved guidance. Most sectors underperformed the general index or declined in May. Telstra dragged telecom lower as it announced the removal of CPI-linked price increases. Consumer staples and consumer discretionary fell on a softening demand outlook. The Top 20 strongly outperformed mid-caps and smaller companies. Finally, value stocks bested growth stocks for the fourth consecutive month.

International Fixed Interest

4 of the 5 major global central banks that met during the month left interest rates unchanged. Those include the FED, the Norges Bank, Norway's central bank, the Bank of England (BOE) and the Reserve Bank of New Zealand (RBNZ). On May 7th, the Riksbank, Sweden's central bank, lowered its key policy rate from 4% to 3.75% and guided for two more cuts in the second half of the year. The Swedish Krona (SEK), which, before the decision, was trading around its all-time lows vis-à-vis the US Dollar, caught a bid, ending the month on a high note. Although the US central bank did not reduce its target rate, it loosened its monetary stance via the other two tools at its disposal, namely "balance sheet" and "forward guidance". In fact, the FED confirmed that, starting in June, it will more than halve the pace of its quantitative tightening, lowering the cap on the amount of Treasury securities rolling off from 60 Bil USD to USD 25 Bil USD each month. In addition, Chairman Powell made it unequivocally clear that the next move is going to be a cut and pushed back against the concerns raised by the recent deceleration of the US economy in the context of a stubbornly high inflation by stating "I don't see the 'stag' or the '-flation'". The yield curve transposed lower in the US while in Europe interest rates were generally higher on uncertainties around the magnitude and the timing of the upcoming easing cycle. Credit spreads were marginally tighter, with high yield and emerging markets the biggest winners. The Bloomberg Barclays Global Aggregate Index hedged back to AUD was up +0.77% for the month.

Australian Fixed Interest

Domestic macroeconomic data published in May continued to provide mixed signals. On the one hand, the headline unemployment rate increased to 4.1% in April, along with the participation rate which reached 66.7%. On the other hand, the ABS monthly measure of consumer price inflation accelerated to +3.6% YoY in April, up from +3.5% in March. On May 7th, the RBA held the cash rate at 4.35% and retained its neutral stance, although during her post-meeting press conference Governor Bullock admitted that the possibility of a rate hike had been discussed, but the board had decided against it. The Australian yield curve experienced a negligible flattening, with the 2 year rising 2 Bps to 4.12% and the 10 year declining 1 Bps to 4.41%. The Bloomberg AusBond Composite 0+ Yr was up +0.39% for the month, while the Australian Dollar strengthened vis-à-vis all major developed and emerging currencies.

Real Assets

Global property was up +3.37% in USD terms and +0.97% in AUD terms in May. Europe, US and Australia outperformed the general index, while Asia bucked the trend. Equinix, a leading data centre REIT, that in March became the target of a well-known short seller over its accounting practices, announced the conclusion of its internal investigation which confirmed the accuracy of the company's financial reporting. The news ignited a violent short-squeeze in the name.

Global infrastructure recouped all losses, advancing +6.09% in USD terms and +3.63% in AUD terms for the month. US electric utilities continued their strong run, while telecom infrastructure and renewables returned to outperformance. Within transportation, airports shone while toll roads and rail lagged.

Alternatives

Alternatives (+0.50%) underperformed global equities in May. Long/Short equities gained, while CTA and managed futures were caught out by the abrupt reversals in interest rates and commodities.

Market Outlook

The CPI report for May 2024 came in cooler than expected, surprising consensus expectations to the downside on both a headline and core basis for the first time since October 2023. The US inflation rate was unchanged MoM, following a +0.3% increase in April, while it decelerated YoY to +3.3% from +3.4%. The US CPI Core, which excludes the more volatile food and energy components, grew +0.2% MoM, following a +0.3% increase the previous month, and slowed YoY to +3.4% from +3.6%. Finally, the 16 Trimmed-Mean CPI calculated by the Federal Reserve Bank of Cleveland, which tracks underlying inflation trends by removing volatile items, came out at +3.42% YoY, its lowest reading since August 2021. In addition, when measured on a MoM basis, it experienced its largest deceleration since January 2021, at +0.13%. A decrease in the gasoline index and flat grocery costs, prompted by the softening that occurred in the prices of energy and agricultural commodities since Q4 2023, provided relief to the headline rate. Within the core measure, the major contributor to the positive surprise was weakness in a variety of transportation sector components. Conversely, shelter remained elevated, rising +0.4% MoM for the 4th consecutive month and +5.4% from a year ago.

According to an astute commentator, there may be an interesting dynamic at play between wage and housing inflation at present caused by the large wave of immigration that has recently hit the US. John Burns Research and Consulting (JBREC) has estimated that in 2023 immigration fuelled the highest one-year growth ever in the US population, at +3.8 million individuals. In a paper released on May 22nd, the Federal Reserve of Kansas City has written that “higher-frequency data” suggests that the actual net number of international migrants that entered the US last year “may have been as high as 3 million”. That influx of workers “appears to have helped alleviate the severe staffing shortages in certain industries that were pervasive during the pandemic’s volatile period” and “dampened wage pressures across the affected industries and states”. However, surging immigration is also supporting housing demand, primarily rentals. As a result, there currently appears to be a trade-off between sticky shelter inflation and a moderating service inflation, whereas the former could be the price to pay for the latter. If that thesis is correct, the long-awaited disinflation in shelter may continue to prove elusive, also considering the fact that in Q1 2024 US house prices recorded their 4th consecutive quarter of reacceleration, increasing more than +6% YoY.

In any case, the report brought much awaited relief to the FED as CPI monthly readings consistently in the range of about +0.2% are required to return back to the 2% target. The numbers were released on June 12th at 8:30am Eastern Time (ET), that is, on the same day as the FOMC meeting. The latter happened at 14:30pm ET, and during his press conference Chairman Powell acknowledged that the members of the board “were able to consider whether they should make changes” following the positive news. The central bank could have taken a victory lap, but surprisingly it chose not to do so. Instead, it maintained its target rate at the current range of 5.25%-5.50% (as expected) and adopted a more hawkish stance with the release of the new Dot Plot, which projected only one rate cut before the end of the year (versus 3 previously), and 4 cuts in 2024 (no change). It also upgraded its median projections of PCE inflation and Core PCE inflation for 2024 to +2.6% (from +2.4%) and to +2.8% (from +2.6%). In short, the central bank guided for a cumulative easing of 125 Bps in the next 18 months, 50 Bps less than what it communicated to the market back in March. Nevertheless, it confirmed that it is comfortable starting the easing cycle well before the rate of inflation reaches 2%. In fact, the return to price stability is now postponed to 2026, that is, 5 years after prices went above the target for the first time.

It is important to bear in mind that the Dot Plot and the summary of economic projections are part of the “forward guidance” tools employed by the FED to influence markets, so they have to be read as a statement of intent, rather than a forecast. In other words, the central bank is conveying a message aimed at prompting a market reaction that will produce the desired outcome. Our interpretation of its latest communication is that the central bank does not want a repeat of the easing in financial conditions that occurred following the announcement of its long awaited pivot in December 2023. Back then, interest rates declined, credit spreads tightened and equities exploded higher, inducing a “wealth effect” that, in the highly financialized US economy, quickly flew through to consumers, contributing to the re-acceleration in inflation observed in Q1 2024. In our opinion, the FED remains dovish, a fact demonstrated by its decision to aggressively curtail its Quantitative Tightening (QT) program despite the US banking system remaining flush with liquidity and we think that it remains on track to deliver 2 cuts this year. However, it needs the disinflation process to continue in the following months, and by that we do not mean achieving the (in)famous “last mile”, that is, getting from +3% to +2%, but just having a few more prints pointing in the correct direction. Given the fact that consensus forecasts for headline CPI and core CPI remain elevated, inflation may continue to surprise on the downside, providing the necessary coverage to the central bank.

The FED and the US Treasury seem to us to be aligned in their desire of lowering inflation from the current level, at least in the short term. Janet Yellen has signalled that she intends to tighten financial conditions by issuing an enormous amount of government bonds that carries interest rate risk in Q3 2024. For that reason, we see US yields range bound, 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. In the first two weeks of June, the correlation between stocks and bonds has flipped back to positive, that is, they have rallied together. The MSCI AC World Daily TR has hit new all-time highs, but looking under the hood, the positive momentum has been concentrated in mega cap growth and defensives, while several investor darlings such as Latin America, Europe and selected cyclical sectors, primarily industrials and materials, have taken a hit. In short, a “flight to quality” rather than a broadening of the rally seems to be taking place in the equity space, a circumstance that may presage a return to a negative correlation between stocks and bonds, if and when, the US economy finally buckles. For its part, the Rest of the World continues to exhibit “green shoots” after having gone through some sort of economic adjustment via slowdown, stagnation or a “technical” recession in 2023. In such a scenario, the bias should be for a stable or

softening US Dollar, with positive repercussions on risk assets. In addition, the so-called “FED put” is operative again, and that should cushion any potential drawdown should volatility pick up during summertime (in the Northern Hemisphere). Putting it all together, we do not see any particular reasons to reduce our exposure to growth assets at the current juncture. That said, the risk/reward for bonds appears to be superior to that of equities going into the second half of the year.

AZ Sestante

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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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