Monthly Market Commentary with Portfolio Manager, Andrea Ciaccio

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Market Review

With around 375 million eligible voters in 2024, the European Parliament represents the second-largest democratic electorate in the world. It is directly voted into office every five years by the citizens of the 27 countries being part of the European Union (EU). However, its legislative power is limited to approving, rejecting or proposing amendments to most, but not all, the laws presented by the European Commission, the only institution that holds the right of initiative. For that reason, European elections have long been considered as a low stakes vote compared to national elections. Historically characterized by a lower turnout, they are often prone to the "protest voting" phenomenon, where citizens cast a more radical ballot than they would have normally done to convey their dissatisfaction with the incumbent, national government. On June 9th, the citizens of the EU went to the ballot box and, judging by the results, they voiced growing political discontent. Centre-right parties triumphed in 14 countries out of 27; as a result, the European People's Party (EPP) managed to hold its position as the largest grouping with 26.11% of the seats, followed by the centre-left Progressive Alliance of Socialists and Democrats (S&D) (18.89%). Despite winning only in 5 smaller countries, the latter bloc managed to secure the second position in Italy and Spain, respectively the third and fourth largest country in terms of Members of the European Parliament (MEPs) allocated.

Far-right, nationalist and populist parties made significant gains, winning more than 30% of the preferences in Austria, Czech Republic, France and Hungary. They gathered in a new group called the Patriots for Europe (11.67%), becoming the third largest force in the EU parliament. Hard-right parties got more than a third of the votes in Italy, Latvia and Poland, propelling their group, the European Conservatives and Reformists Group (ECR) (10.83%), to the fourth place, overtaking the liberals of Renew (10.69%), the biggest election losers. The Greens (7.36%) fell to sixth place, primarily due to slumping support in Germany; there, the far-right party Alternative for Germany (AfD) came second and formed a new bloc in Brussels called Europe of Sovereign Nations (ESN) (3.47%) together with other extremist parties. The AfD was recently expelled from the now dissolved Identity and Democracy (ID) group, which reorganised and changed its name to Patriots for Europe, after a series of scandals, including comments by the party's lead candidate that appeared to downplay the membership of Germans in the infamous Nazi SS.

In France, the National Rally (RN) of Marine Le Pen won the European elections, securing more than twice the vote casted for President Emmanuel Macron's party. On the back of its stunning domestic success, it became the largest national delegation in Brussels with 30 MEPs (out of 720), surpassing even the German CDU/CSU, which received 29 seats. The results of the French elections did not come as a shock, they rather mirrored the polls. However, following his crushing defeat, Macron surprisingly decided to dissolve the National Assembly and call for new parliamentary elections. The CAC 40, France's blue-chip benchmark, fell the most in 2 years following the news. More worryingly, the 10-year OAT/Bund spread, that is, the difference between the yield paid by the French government and the yield offered by the German government, widened by 32 Bps to 80 Bps, respectively the most since October 2011 and the highest level since August 2012.

France is the second largest economy in the EU with a GDP of 2.92 trillion USD, behind Germany (4.31 trillion USD); however, it ranks first in terms of national debt, which at the end of 2022 stood at 3.14 Trillion USD. France is the seventh largest economy in the world, but the fourth largest debtor, behind the US, Japan and China. It also has the (un)enviable distinction of being one of the 10 developed countries whose national debt exceeded 100% of its GDP at the end of 2023 (110.60%). In addition, France's budget deficit expanded to 5.5% of GDP last year, way above the 3% deficit ceiling set by Brussels and wider than the 4.9% target, on the back of lower-than-expected revenues, discretionary tax cuts and an absence of structural savings measures. The country was also in primary deficit (3.3%), that is, government's outlays were higher than receipts even excluding interest payments, which accounted for around 2% of GDP.

Foreign investors own around 50% of France's overall government debt, much higher than around 28% in Italy, 40% in Spain and 45% in Germany. For Japanese investors French bonds are the second most popular overseas debt after US notes; at the end of 2023, they held 25 trillion JPY in French debt, including corporate bonds, equivalent to around 160 Bil USD. According to several market analysts, the timing of France plunging into political uncertainty couldn't be worse. In fact, the European Central Bank (ECB) has just cut its deposit rate for the first time since September 2019, while futures markets are currently pricing that the Bank of Japan (BOJ) will hike rates by 25 Bps in 2024 and by 50 Bps in 2025. That divergence in the trajectory of monetary policies is bound to happen at a time the Japanese Yen (JPY) has just dropped to new all-time lows vis-à-vis the Euro, having lost close to -20% in the last two years alone. Whether Macron's gamble ends up paying off, it may have created a powerful incentive for Japanese investors to repatriate their capital.

International Equities

US equities rose in June, with the S&P 500 (+3.47%) and the Nasdaq 100 (+6.18%) hitting new all-time highs. The Dow Jones Industrial was up a more modest +1.12%, ending the month -2.39% below its peak recorded on May 20th, while the Russell 2000, the popular benchmark for smaller companies, bucked the trend, down -1.08%. Mega cap growth reigned supreme in June, with technology and consumer discretionary posting gains and outperforming the general index. High dividend and low volatility stocks suffered losses. Communication services, real estate and healthcare ended the month in the black but could not keep up with the S&P 500. All other groups declined as the breadth of the market rally narrowed to multi-year lows. The S&P 500 Equal Weight Index (-0.65%) recorded its 6th worst monthly underperformance ever vis-à-vis the market cap weighted index as the "Magnificent Seven" trounced the remaining 496 stocks by the most since May 2023; as a result, at the end of June they accounted for a record 31% of the S&P 500. The positive momentum in semiconductors continued and, on June 5th, Nvidia joined the so called "3 Trillion Dollar Club" of companies, currently comprising Microsoft and Apple. The chip giant managed to hit that milestone just 66 trading days after

hitting 2 trillion in value; it took Apple and Microsoft 719 and 650 trading days respectively to achieve the same result. On June 18th, Nvidia narrowly topped Microsoft's market capitalization to become the world's most valuable public company. Its weight in the S&P 500 briefly breached above 7% before a -8.88% correction took it back to 6.61% at the end of the month.

US equities strongly outperformed the rest of the world (as exemplified by the MSCI AC World Index ex USA TR Index) in June. Emerging markets were the best performing region as weakness in China was more than compensated by explosive rallies in the AI beneficiaries South Korea and Taiwan. Japan was weighed down by the continuous depreciation of its currency, while Europe dropped on renewed concerns regarding fiscal sustainability within the EU. Finally, the MSCI World Growth recorded its 10th best monthly outperformance ever vis-à-vis the MSCI World Value Index. All in all, the MSCI AC World Daily TR was up +2.23% in USD terms and +1.71% in AUD terms.

Australian Equities

Australian equities lagged their international peers in June as the S&P/ASX 300 added +0.92%. Financials were the best performing sector, buoyed by the strong returns generated by banks and insurance. Healthcare and telecom bested the general index as CSL and Telstra rebounded. Utilities, consumer staples and consumer discretionary posted strong gains, while technology outperformed, consolidating its lead over the other sectors since the beginning of the year. June 20th was the first day of trading of Guzman y Gomez Ltd., a Mexican-themed fast-food chain; its shares jumped +36.36%, the biggest gain for an Australian IPO debut larger than 100 mil AUD since 2020. Resources bucked the trend as miners dropped on softening copper and iron ore prices, while energy was dragged lower by weakness in refiners. Mid-caps and smaller companies ended the month in the red, strongly underperforming the Top 20. Finally, value stocks bested growth stocks for the fifth consecutive month.

International Fixed Interest

5 of the 8 major global central banks that met during the month left interest rates unchanged; those include the FED, the Bank of Japan (BOJ), the Norges Bank, Norway's central bank, the Bank of England (BOE) and the Riksbank, Sweden's central bank. However, June was the month with the highest number of rate cuts delivered by G10 central banks since March 2020. On June 5th, the Bank of Canada (BOC) reduced its benchmark overnight rate by 25 Bps, from 5% to 4.75%, on fresh data pointing to a "soft landing" of the domestic economy. On June 6th, the European Central Bank (ECB) lowered its policy interest rate from 4% to 3.75%, as expected, but declined to provide guidance on the future rate path. Finally, on June 20th, the Swiss National Bank (SNB) reduced its policy rate for the second time, from 1.5% to 1.25%, on the back of lowered inflation forecast and a strong Swiss Franc (CHF) benefiting from the turmoil in Europe. The yield curve transposed lower in US, while the strong rally in credit spreads took a pause, as only high yield managed to outperform government bonds. Investors took profit from emerging markets and leveraged loans. The Bloomberg Barclays Global Aggregate Index hedged back to AUD was up +0.78% for the month.

Australian Fixed Interest

On June 18th, the RBA held the cash rate at 4.35% but adopted a more hawkish language in the accompanying statement, reaffirming that "the Board is not ruling anything in or out" as "inflation remains above target and is proving persistent". During her post-meeting press conference, Governor Bullock reinforced the message by saying that the central bank is "alert to the upside risks". The ABS monthly measure of consumer price inflation accelerated to +4.0% YoY in May, surpassing estimates of 3.8%; as a result, the cash futures moved to price in a hike before the end of the year. The Australian yield curve flattened further, with the 2-year rising 4 Bps to 4.16% and the 10 year falling 10 Bps to 4.31%. The Bloomberg AusBond Composite 0+ Yr was up +0.77% for the month, while the Australian Dollar strengthened vis-à-vis all major developed and emerging currencies.

Real Assets

Global property was up +0.42% in USD terms but mostly unchanged (-0.08%) in AUD terms in June. US and Australia outperformed the general index, while Europe and Asia suffered steep losses.

Global infrastructure fell -2.96% in USD terms and -3.44% in AUD terms for the month. US electric utilities gave back a large chunk of the gains generated in May, while European infrastructure stocks sold off on nationalisation concerns, primarily in France.

Alternatives

Alternatives (+0.24%) posted mixed returns in June. Upside capture for Long/Short equities was muted as managers reduced their exposure to technology and momentum during the month. Discretionary macro and CTA and managed futures failed to capitalize on increased geopolitical risk.

Market Outlook

On July 11th, the Bureau of Labor Statistics (BLS) released the inflation data for June. The US CPI fell for the first time in more than 4 years, down -0.1% MoM, amid cheaper gasoline and moderating rents. It was the second consecutive report which showed monthly readings consistent with a return to the 2% target. Equity investors reacted to the positive news by selling the winners of the first half of the year, primarily mega cap growth and the "Magnificent Seven", and buying the laggards, first and foremost regional banks and small caps. The S&P 500 and the Nasdaq 100 were down -0.88% and -2.24% respectively, dragged lower by their largest constituents, Microsoft (-2.48%), Nvidia (-5.57%) and Apple (-2.23%), which together accounts for more than 20% of both indices. Conversely, the Russell 2000 jumped +3.57%, outperforming the S&P 500 by 445 Bps in one day, a 6 standard deviation event, that is, something that is supposed to happen once every billion years if markets followed a normal distribution. The outperformance of small caps has persisted in the subsequent days and, at the time of writing of this note (July 17th), the Russell 2000 is up +10.34% in 4 sessions, which compares exceptionally well with the +0.59% generated by the S&P 500 over the same period. We think that it is too early to infer a long-lasting regime change in market leadership. In the past 18 months, the "American exceptionalism" theme has prompted an extreme crowding into US Big Tech, and the violent rotation currently underway may just be a (partial) unwind of said trade. We also do not subscribe to the thesis that the market may have just started to position for a Trump presidency and/or for a Republican clean sweep, for the simple reason that technology was the best performing sector in the first year following the 2016 election, and by a large margin. We currently see three scenarios for US equities going forward: a "bubble", a "broadening" or a "bust".

In our opinion, the economy and the markets have been caught in a reflexive loop in the past two years in which signs of a slowdown in the former has brought about a loosening in financial conditions in the latter, ultimately preventing the inflation rate to soften enough for the FED to actually deliver an easing of its monetary policy. This is because the current economic cycle has been primarily driven by income growth rather than credit growth, and, as a result, the positives of the so-called "wealth effect" have always trumped the negatives of high or higher interest rates. To illustrate the above point, let's go back to the beginning of 2023, when the consensus was predicting a recession with a 70% probability. At that time, bond futures were pricing in rate cuts for the second half of the year, and the Russell 2000 was starting to outperform the S&P 500. However, "Bidenomics" had just started to kick in, causing a massive increase in deficit spending on the part of the government. Then, in March, the FED reacted to the regional bank crisis by a robust injection of liquidity to avoid a credit crunch that, in fact, did not materialize. Instead, the economy started to reaccelerate, bond futures were forced to replace cuts with hikes and the US yield curve transposed higher. With no loosening cycle in sight, investors piled in the S&P 500 and shunned the Russell 2000 once again, causing a dramatic underperformance of the latter vis-à-vis the former. The same exact dynamic repeated in Q4. Interest rates fell sharply on the back of the double pivot, first of the US Treasury, which opted to finance a substantial part of the burgeoning public debt with bills, and then of the FED, which officially announced its intention to cut rates in 2024. Consequently, at the beginning of this year, bond futures were pricing in 100 Bps of easing and the Russell 2000 was rocketing higher. This time, the economy continued to gently slow down, but we got three bad inflation prints in January, February and March. The 10-year yield moved from 3.8% to 4.7%, Barron's put a picture of Chairman Powell on its cover with the title "why he won't cut rates this year" and the S&P 500 trounced the Russell 2000 once more.

The "bubble" scenario is simply the continuation of the current predicament, that is, the relentless outperformance of the S&P 500 caused by investors crowding into mega cap growth in the belief that these behemoths will make money even if the FED remains restrictive. In fact, as long as interest rates remain high and the economy does not enter a recession, the ever more expensive "Magnificent Seven" arguably represent a better alternative to, on the one hand, the Russell 2000 or the remaining 496 stocks comprising the S&P 500, and, on the other hand, the duration trade. In a world in which passive flows trump fundamentals most of the time, paying 30+ times earnings and 8+ times sales for the best companies around is highly likely to beat a strategy of accumulating companies that are cheap, but whose prospects are uncertain. However, given that the US economy has uniquely remained in the so-called "late cycle" phase for an extended time, it is conceivable that it may be about to exit the reflexive loop described above. That is, the "wealth effect" originating from a budget deficit out of control, financial assets and housing valuations at all-time highs and declining interest rates, may not give rise to a reacceleration in economic activity and/or inflation in the foreseeable future. In such a scenario, the cuts currently priced in the US yield curve are finally going to be administered, with the first one coming already in September. But there is an important distinction to be made here. If the FED cuts in the context of a "soft landing", or, as pointed out by an astute commentator, of a "slowly slowing economy", we think that the most probable outcome for US equities will evolve into a "broadening". This seems to be what markets have started to anticipate now; suddenly, the prospects of cheap companies have become less uncertain, thus rendering their valuations too attractive to pass on. The end result may be that major indices remain rangebound, and that gains will be found primarily in sector and factor rotation, that is, in active management. Conversely, if the "long and variable lags" of monetary policy have done enough to damage the economy, and the FED is cutting at the onset of a recession, its actions will not spare the stock market from a "bust", that is, equities will move lower in unison.

The Q2 2024 earnings season has just started, and we suspect that the markets will continue to "broaden" during summertime (in the Northern Hemisphere) given sky-high expectations for mega cap growth, and a relatively lower bar for the rest of the market. For that reason, we do not see particular reasons to reduce our exposure to growth assets at the current juncture. In addition, 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, and during the first two weeks of July the US Dollar has broken down to its lowest level since March, which bodes well for risk assets. That said, historically volatility tends to pick up going into August, and investors may have gotten too complacent by the recent grind higher. A correction may be in the cards, but it is premature to assume that the so-called "FED put" will fail to cushion any potential drawdown. In other words, we do not find it prudent to hedge the "bust" scenario by acting in the

equity space. Rather, we expect bonds to provide our portfolios with the necessary diversification in a potential adverse outcome. The disinflation process seems to be entrenched, and we think that headline CPI and core CPI may continue to surprise on the downside in the next few months. Putting it all together, 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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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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