

Market Review

A “prediction market” is an exchange that allows its users to trade binary contracts whose payoff depends on the outcome of various unknown future events or in plain English, to place “yes-or-no” bets on real-world events. Polymarket and PredictIt, the most popular platforms, use a continuous double auction model that matches buyers to sellers and in which the price of the option in cents represents the probability of the event occurring, rising when confidence in the outcome increases and falling when it decreases. Since 2020, political betting has gained a greater share of trading volume, as the types of political wagers have diversified and now encompass traditional bets on electoral outcomes as well as predicting specific political events or decisions. At the end of July, more than 1 Bil USD had been traded on Polymarket since the beginning of the year, with over 600 mil USD staked on the US presidential election winner alone and 7 out of the 10 biggest bets being related to US politics. According to their advocates, prediction markets are an effective method of harnessing the so-called “wisdom of the crowd”, as they enable the aggregation of the knowledge base and informed opinions of a large, diverse and independent population, providing more accurate results than polling. However, the Commodity Futures Trading Commission (CTFC), a top Wall Street regulator tasked with overseeing US derivatives markets, is a powerful detractor of event contracts and back in May it issued a new rule proposal that would effectively ban them. According to its Chair Rostin Behnam, those financial products threaten to “commoditize and degrade” the integrity of US elections. For their part, speculators cannot seem to get enough of political betting on the back of one of the most unpredictable and volatile US presidential election in decades, which in July saw a major reconfiguration.

Following the “unmitigated disaster” of his “horrific” performance (in the words of the Economist) during the first (and so far, last) presidential debate held on June 27th, the odds of re-election of US President Joe Biden on PredictIt plunged from 45% to 21% in just over a week. In the meantime, Donald Trump consolidated his lead at the margin, improving from 55% to 58%. On July 13th, the former US President was the victim of an assassination attempt while speaking at an open-air campaign rally in Pennsylvania. A bullet grazed his ears, leaving him bloodied but not seriously injured. An “iconic” photograph of a “defiant” Trump pumping his fist in the air and shouting “Fight! Fight! Fight!” while being rushed off stage went viral, prompting his odds of election to spike to 65%. Two days later, Trump made his first public appearance since the shooting at the Republican National Convention in Milwaukee. There he picked J. D. Vance as his running mate, a decision that did not exactly come as a surprise. In fact, in the two weeks leading up to the event, the odds of the 39-year-old Ohio Senator being nominated had steadily increased from 22% to 50%. Vance is the first millennial to join a major-party ticket. He comes from humble beginnings in the Rust Belt, which he describes in his 2016 memoir “Hillbilly Elegy”. A “Never Trumper” Republican in 2016, two years ago he converted to be one of the staunchest supporters of the “Make America Great Again” agenda. Finally, he is a protégé of Silicon Valley’s billionaire venture capitalist Peter Thiel and, according to the Washington Post, he is seen by some of tech’s biggest names “as their emissary in Washington”. Following his nomination, the odds of Trump re-taking the White House peaked at 69%.

However, in an historic move on July 20th, Biden dropped out of the race and endorsed US Vice President Kamala Harris. Once again, both events were correctly presaged by prediction markets. In fact, following the “dismal” debate, the odds of Harris being elected had already shot up from 4% to 25%. At the same time, Polymarket users were consistently pricing a 60-70% chance of Biden quitting. The “passing of the torch” seems to have re-energized the Democrats and galvanized young voters, women in particular. As a result, Harris’ candidacy has gone from strength to strength since the announcement, culminating in her overtaking of Trump on the very last day of the month, when PredictIt odds flipped in her favour 53% versus 49%. Harris and Trump are both considered “populist” candidates, and market participants expect them to continue to run a large budget deficit if elected. However, while the former may have big spending plans for her presidency, it is unclear whether her administration would renew the Tax Cuts and Jobs Act (TCJA) implemented by Trump in 2017 and set to expire at the end of 2025. In addition, Harris has long been in favour of higher corporate tax rates and of imposing a financial transaction tax. As a result, a fiscal drag may be on the cards should she prevail on November 5th. It is assumed that her policies will be “inflationary”, but to a lesser extent than Trump’s ones. In fact, the latter is running on a platform of widespread tax cuts, increased import tariffs and curbed immigration. Back in April, it was revealed that his close economic advisers were drafting plans to debase the US Dollar by pressing other countries to revalue their own currency and to erode the FED’s independence by giving the president himself a role in setting interest rates. Finally, he has recently embraced crypto currencies, promising to make the US a “bitcoin superpower” and the “crypto capital” of the world.

International Equities

Market rotation and a “broadening” of the rally were the main themes of July. US equities were mixed, with the S&P 500 adding +1.13% and the Nasdaq 100 shedding -1.63% in USD terms, the biggest divergence between the two averages since December 2022. Both the S&P 500 Equal Weight Index (+4.39%) and the “Old economy” heavy Dow Jones Industrial (+4.41%) hit new all-time highs during the month, with the latter index outperforming the “New economy” heavy Nasdaq 100 by the most since October 2022. The Russell 2000 (+10.10%), the popular benchmark for smaller companies, exploded higher, recording its 7th best outperformance ever vis-à-vis the Russell 1000. The “Magnificent Seven” ended the month in the red, dragged lower by Microsoft, Nvidia, Amazon, Meta and Alphabet. Conversely, Apple rose to reclaim the title of world’s most valuable public company, becoming once again the largest constituent within the S&P 500. Tesla jumped double-digits, as short sellers were forced to cover their positions amidst a violent “short squeeze” prompted by a better-than-expected deliveries report for Q2. Technology and communication services were the worst performing sectors in July, while real estate, utilities, financials, industrials and materials all posted strong gains and outperformed the general index. As a result, the S&P 500 Low Volatility TR and the S&P 500 High Dividend Index TR bested the S&P 500 High Beta TR in the context of a generally “risk-on” tone across markets.

US equities underperformed the rest of the world (as exemplified by the MSCI AC World Index ex USA TR Index) in July. Japan was the best performing market on the back of a sharply appreciating currency. During the first half of the month, the Nikkei 225 index surged above 42,000 for the first time in history, before giving back all its gains and closing July in negative territory. However, the Japanese Yen (JPY) rallied +8.40% vis-à-vis the Australian Dollar, its best month since September 2011. Europe outperformed despite an inconclusive French parliamentary election in which no political party managed to achieve an outright majority. South East Asia caught a bid, though Emerging markets lagged overall. Finally, the MSCI World Value recorded its 8th best monthly outperformance ever vis-à-vis the MSCI World Growth Index. All in all, the MSCI AC World Daily TR was up +1.61% in USD terms and +3.84% in AUD terms.

Australian Equities

Australian equities outperformed their international peers in July, as the S&P/ASX 300 soared +4.13%, its best month since December 2023. The S&P/ASX 200 ended the month on a strong note, closing above 8,000 for the first time ever. Consumer discretionary was the best performing sector, driven higher primarily by retailers. Financials were buoyed by the strong returns generated by banks and A-REITs. During the month, CBA became the world's 12th largest bank in terms of market capitalization. Industrials, healthcare and telecom bested the general index while technology and consumer staples lagged. Resources and utilities bucked the trend, as both sectors were dragged lower by index heavyweights. Mid-caps and smaller companies posted strong gains but could not keep up with the Top 20. Finally, value stocks bested growth stocks for the sixth consecutive month.

International Fixed Income

The trajectory of monetary policies pursued by major economies diverged in July. 3 of the 6 major global central banks that met during the month kept interest rates unchanged. Those include the Reserve Bank of New Zealand (RBNZ), the European Central Bank (ECB) and the FED. On July 24th, the Bank of Canada (BOC) reduced its benchmark overnight rate by 25 Bps for the second consecutive month, from 4.75% to 4.50%. In addition, the cash futures moved to price in 3 more cuts before the end of the year, that is, one for each of the central bank's remaining monetary policy decisions in 2024. Since June, concerns have mounted that inflation may drop too far below the 2% target. On July 31st, the Bank of Japan (BOJ) surprised markets by lifting its benchmark rate to 0.25%, its highest level since December 2008, from a range of 0% to 0.10%. It is the second hike in 2024 and comes just four months after the monetary authority ended 8 years of negative interest rates policy (NIRP). In addition, Governor Kuroda stated that another hike this year may not be ruled out and unveiled a Quantitative Tightening (QT) plan that would reduce the central bank's balance sheet by up to 8% as of Q1 2026.

In the US, the yield curve transposed lower and bull steepened. The 2 year yield fell 50 Bps, the most since March 2023, as investors priced in a cut of the same magnitude at the upcoming FOMC meeting in September. Credit spreads tightened across the board, with all segments outperforming government bonds. The Bloomberg Barclays Global Aggregate Index hedged back to AUD rose +1.88% for the month.

Australian Fixed Income

After falling for 5 consecutive quarters, domestic headline inflation quickened modestly to +3.8% YoY (from +3.6%) in Q2 2024, in line with the RBA's forecast, as both the services and the goods components exhibited renewed price pressures. However, the Australia Monthly CPI Trimmed Mean, the measure preferred by the central bank, decelerated to +3.9% YoY (from +4.0%), missing expectations. As a result, the cash futures moved to price out any potential additional hike. The Australian yield curve bull steepened as the 2 year fell 29 Bps to 3.87 and the 10 year declined 20 Bps to 4.11%. The Bloomberg AusBond Composite 0+ Yr was up +1.48% for the month, while the Australian Dollar dropped sharply vis-à-vis all major developed and emerging currencies.

Real Assets

Global property exploded higher in July, up +6.12% in USD terms and +8.45% in AUD terms. All regions and sectors gained on the back of cooling inflation and economic data. The FTSE EPRA Nareit Developed TR in AUD recorded its 4th best month ever. Global infrastructure rallied +4.44% in USD terms and +6.72% in AUD terms for the month. US electric and UK water utilities, together with energy infrastructure, were the best performing segments, while transportation stocks lagged. The S&P Global Infrastructure TR in AUD recorded its 2nd best month ever.

Alternatives

Alternatives (+0.66%) posted muted returns in July, with performance dispersion expanding during the month. Long/Short equities continued to lag global stock markets, while CTA and managed futures fell for the third month in a row.

Market Outlook

Stock markets around the world suffered a flash crash in the first three trading days of August. The rout started in Asia, with the Nikkei 225 dropping -2.49% on Thursday and -5.81% on Friday, before collapsing -12.40% on Monday, August 5th. The latter was the biggest single day drop of the most popular barometer of Japanese stocks since the -14.9% recorded on October 19th, 1987, the infamous “Black Monday”. On the same day, the VNKY Index, the measure which estimates the expected volatility of the Nikkei 225, shot up to 85.38, its highest reading since October 2008, at the height of the global financial crisis (GFC). US equities, which had started to weaken from the fresh all-time highs reached in mid-July, accelerated their descent. On August 5th, the VIX Index, the measure which estimates the expected volatility of the S&P 500, opened at 23.29, spiked to 65.73 and then plunged to 38.57, the highest ever difference between its intra-day high and close. In the end, the S&P 500 and the Nasdaq 100 fell -9.71% and -15.73% respectively top to bottom, with 70-80% of the total loss incurred between August 1st and 5th. Since then, markets have rallied strongly, recovering most of the losses in a matter of weeks. Moreover, according to a Reuters analysis, it takes the VIX Index 170 sessions on average to return to its long-term median of 17.6 following similar bouts of panic, while in this latest instance things have reverted to calm in just 7.

The disorderly unwind of the carry trade centred around the Japanese Yen (JPY) has been touted as the primary culprit for the wild gyrations recently experienced by markets. So-called “high yielding” currencies the likes of the Brazilian Real (BRL) and the Mexican Peso (MXN), which sport cash rates above 10%, have lost around 20% of their value to the Japanese Yen (JPY) in the blink of an eye on the back of speculators scrambling to close their risky positions and repay the loans denominated in JPY that were funding them. According to the strategists at JPMorgan Chase, by August 12th three-quarters of global currency carry trades had been closed out. Moreover, the weekly reports released by the CFTC show that the speculative positions in JPY have gone from a record net short to flat in 4 weeks, an event last occurred in mid-2007. In short, it seems that what we went through was just another summer shakeout caused by the wipeout of excessive greed, an episode that may not signal the start of something more ominous for markets, at least not yet. We are sympathetic to that thesis, however, we think that the extreme behaviour observed across different asset classes may be indicative of something more fundamental than the blowup of carry trades, and that similar dynamics may manifest again if and when the US economy enters a recession.

There is no denying that US has been the centre of the so-called “hot money” for almost a decade now, attracting capital from all over the world. Initially, it was because of the rise of the technology sector and the FANGs, which later morphed into the “Magnificent Seven”. In fact, those companies have been consistently generating superior earnings growth and have evolved into huge monopolies, becoming de-facto “cash machines”. Following the election of Trump in 2016, and more so in response to the pandemic of 2020 and after the advent of “Bidenomics”, the US government has inaugurated a policy of procyclical deficit spending to prop up the country’s GDP growth potential. Finally, in the last 2 years the FED has raised its target rate aggressively, bringing it to one of the highest levels among major developed economies. As a result, the world has got massively long US assets, and rightly so, as the country was (and still is) offering better equity returns, economic and yield prospects on a relative basis. However, we think that the “American exceptionalism” may have started to reverse its course, and that the turmoil of the first trading days of August may be partly related to offshore investors, primarily from Asia, repatriating their money, and not just to the “death” of the JPY carry trade. In fact, major currencies in the region such as the Chinese Yuan (CNY), the Korean Won (KRW), the Taiwanese Dollar (NTD) and the Singaporean Dollar (SGD) have been on the rise lately. Those countries, together with Japan, have ploughed massive amounts of money into the US, particularly so after a notorious investment bank report published in March 2022 called China “uninvestable”.

In our opinion, carry trade, capital flows, volatility and “American exceptionalism” are joined at the hip. As huge pools of capital reach the US shores to buy the “Magnificent Seven”, the correlation among those stocks and the rest of the market declines. As a few names come to dominate the performance of equity indices, the volatility of the market subsides. The reduction in perceived risk attracts more inflows, with the result that valuations are pushed higher and higher while equity indices become increasingly concentrated. We call this the “bubble” scenario, 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 June, market positioning reached such extreme readings that when, on August 2nd, the Labor Department report showed that the US unemployment rate had jumped to 4.3% in July amid a significant slowdown in hiring, markets snapped. The consensus flipped instantly from “higher for longer” to “emergency cuts”, that is, cuts announced during an interim meeting, in the belief that the US economy had entered or was about to enter a recession. We call this the “bust scenario”, in which investors cut their equity exposure in anticipation of a bear market. Because what they own is primarily US, technology and the “Magnificent Seven”, their selling activity prompts a reversal of the “virtuous” cycle described above. Market volatility explodes higher as enormous positions in the largest constituents of the indices get liquidated, equities and interest rates drop in unison and the greenback weakens as capital leaves US. This is because the pillars of the “American exceptionalism”, superior economic growth, higher earnings and higher yields, are all put in doubt at the same time.

After having gone from “bubble” to “bust” in rapid succession, stock markets seem to have finally settled into the much awaited “broadening” phase. The first FED cut is coming in September, and it is likely to amount to 50 Bps. This is putting downward pressure on the US Dollar as it diminishes the attractiveness of US rates, with positive repercussions on risk assets. However, the US economy appears to be “slowly slowing” and not “hard landing”, thus, GDP growth and earnings, though no longer “superior” to those available in the rest of the world, should not be in immediate danger. In that context, major indices may remain rangebound, with gains to be found primarily in sector and factor rotation, that is, in active management. For that reason, we do not see particular reasons to reduce our exposure to growth assets at the current juncture. Rather, we think that a globally diversified portfolio of equities and real assets may benefit from the gradual unwind of the extreme long positioning in US equities and in the US Dollar that have been built over the years. That will remain our base case until the recession kicks in and large offshore investors decide that the time has come to repatriate their money all at once. In the meantime, the so-called “FED put” is operative again, while loose financial conditions, tight credit spread, lower mortgage rates and contained commodity prices are anything but sounding the alarm.

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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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