

Market Review

A trifecta of policy interventions boosted the outlook for the global economy during the month. On September 18th, the FED kickstarted its long-awaited easing cycle with a bang, lowering its target rate by 50 Bps to a range of 4.75%-5.00%. It was the first cut since March 2020 and came 420 days after the last hike in July 2023, the second-longest pause in FED policy in modern history after 2006-07. Back then, the central bank hiked for the last time in June 2006 and, in a curious historical coincidence, delivered the first cut 446 days later, exactly on September 18th, 2007, when it brought the target rate down from 5.25% to 4.75%. 17 years ago, Chairman Bernanke was looking to cushion the economy from “the worst slump in housing in 16 years”. Fast forward to today, during his press conference Chairman Powell painted instead an upbeat picture of the economy, stating that “the labour market is actually in solid condition, and our intention with our policy move today is to keep it there”. Also, he made it clear that he does not think that the central bank is behind the curve. He stressed that the decision to go big made sense “from a risk-management standpoint”, a message consistent with the concept of an “insurance cut”, that is, a larger reduction in the interest rate aimed at ensuring a soft landing. Not all members of the FOMC agreed with his assessment though. Governor Michelle Bowman dissented in favour of a smaller 25 bps cut, the first dissent by a governor since 2005 and the first dissent from any member of the FOMC since 2022.

Chinese authorities fired the second salvo ahead of the Golden Week holiday with a coordinated blitz of monetary and fiscal policies aimed at shoring up the world’s second-largest economy. On September 24th, the People’s Bank of China (PBOC) unveiled its most aggressive stimulus since the pandemic. During a rare briefing alongside other top regulators, Governor Pan Gongsheng announced the reduction of the mortgage rates for individuals by an average of 50 bps. The measure will impact 5.3 Trillion USD in mortgages, the majority of which charges rates 100-150 bps above current levels, cutting annual household interest expense by an estimated 21 billion USD. In addition, the nationwide minimum down payment on second homes was equalized to that on first homes, prompting a lowering of the former from 25% to 15%. The lending facility for affordable housing launched by the PBOC back in May was strengthened, with the coverage of the loans granted to local governments to buy unsold homes increased to 100% from the initial 60%. Finally, breaking with decades of regulatory frameworks, the PBOC unveiled a new program which will allow institutional investors and corporates to borrow at a rate of around 1.75% to purchase shares or to execute buybacks. The proposed cost of funding compares favourably with the dividend yields of 3% and 4% offered by the A-shares traded on the domestic market and the H-shares traded on the Hong Kong market respectively.

A surprise easing of the fiscal stance followed two days later, with the 24-man Politburo (China’s highest governing body) pledging more support for the economy and vowing to meet the country’s growth target for 2024 of roughly 5%. For the first time ever, officials explicitly targeted the real estate market in their communication, promising to prevent further declines in the sector. While few specifics of the new fiscal plan were provided, it was reported that the government is considering the issuance of a massive 420 billion USD of special government bonds to recapitalize state-owned banks, which will be negatively affected by lower mortgage rates, to assist the deleveraging of local governments by refinancing their off-balance sheet debt and to subsidize consumers. The provision of a one-off cash handout to residents facing hardship and the extension of social security benefits to certain categories like college graduates who haven’t found a stable job two years after leaving school were also enacted to bolster public confidence and increase demand. If all are implemented, China’s “bazooka” could be as big as 3% of GDP and, despite a size deemed insufficient by several economists, it has the potential to reignite the “animal spirits”, at least temporarily.

The final jolt came from Saudi Arabia which, on September 26th, communicated via the Financial Times that OPEC+ is committed to raising production as planned on December 1st, even if that leads to a prolonged period of lower prices. The report states that the Kingdom is ready to abandon its unofficial price target of 100 USD a barrel, the threshold required to balance its budget (per the IMF), to win back market share. The OPEC+ oil output is estimated to have declined to only 48% of the world supply, an all-time low, based on the International Energy Agency (IEA) figures and Reuters calculations. Worse still, Saudi Arabia’s contribution is projected to have slipped below 10% of total production on the back of the voluntary cuts of about 2 million barrels per day it has implemented since late 2022. While the country remains the largest oil exporter, the US has been the leading oil producer since 2018, pumping a record-high 12.9 million b/d on average in 2023. Oil, which was already trading in negative territory since the beginning of the year, extended losses following the release of the article. Lower crude prices tend to translate into higher spending, supporting global growth, and come at a timely juncture given the escalating tensions in the Middle East.

International Equities

US equities rose for the fifth consecutive month. The S&P 500 (+2.02%) and the Dow Jones Industrial (+1.85%) broke to new all-time highs, while the Nasdaq 100 (+2.48%) closed the month above 20,000 for the first time in its history, though remaining below its early July peak. At the end of September, the S&P 500 was up +20.81% in USD terms since the beginning of the year, its best stretch in the first 9 months of a year since 1997. Following two months of underperformance, the “Magnificent Seven” came back with a vengeance, trouncing the rest of the market by 500 bps. Investors snapped up speculative stocks, with the S&P 500 High Beta TR besting the S&P 500 Low Volatility TR by the most since February. Consumer discretionary was the best performing sector, followed by utilities. Communication services, industrials and real estate posted solid gains, while energy, healthcare and financials bucked the trend, ending the month in the red.

US equities underperformed the rest of the world (as exemplified by the MSCI AC World Index ex USA TR Index) in September. All major regions were down in AUD terms for the month, with the only exception being emerging markets, which capitalized on a surge in the Chinese stock market. The CSI 300 Index, which tracks the performance of the largest stocks traded in Shanghai and in Shenzhen, jumped +20.97%, its 3rd best month ever. Returns for the offshore market were even greater, with the CSI Overseas China Internet, which tracks the performance of the largest Chinese Big Tech firms, exploding +35.36%, its 2nd best month ever. The MSCI ACWI Equal Weighted TR Index, which holds a 24.16% exposure in China, recorded its 3rd best month ever vis-à-vis the general index. All in all, the MSCI AC World Daily TR was up +2.32% in USD terms but down -0.35% in AUD terms.

Australian Equities

Australian equities outperformed their international peers in September in AUD terms. The S&P/ASX 200 rallied smartly to notch another record-high monthly close. The S&P/ASX 300 soared +3.07%, with positive contributions coming from materials, technology and A-REITs. Investors rotated away from banks and into resources, helping the latter sector curtail the largest 12-month lag since 2021 vis-à-vis the former. BHP Group, Rio Tinto and Fortescue rose double-digits as copper and iron ore prices ripped higher following the slew of announcements coming from China. Conversely, healthcare and consumer staples bucked the trend, led lower by the respective index heavyweights. CSL fell on the back of a temporary change in its senior leadership team. Woolworths and Coles declined after the Australian Competition & Consumer Commission (ACCC) sued them over claims of “illusory” discounts. Mid-caps and smaller companies outperformed the Top 20, while growth stocks broke a 7-month losing streak vis-à-vis value stocks.

International Fixed Income

Global central banks cut by a cumulative 150 bps in September, delivering the largest decrease in interest rates since the easing wave at the onset of the pandemic. On September 4th, the Bank of Canada (BOC) reduced its benchmark overnight rate for the third time since June, from 4.50% to 4.25%. On September 12th, the European Central Bank (ECB) lowered its policy interest rate for a second time, from 3.75% to 3.50%. In her press conference, President Lagarde reiterated that policymakers were not “pre-committing to a particular rate path”, appearing to suggest that a further rate cut at the next meeting in October was not a given. On September 18th, the FED brought the number of rate-cutting central banks to 7 and became the first major central bank to reduce interest rates by more than 25 basis points during the current cycle. On September 25th, the Riksbank, Sweden’s central bank, lowered its key policy rate for the third time in 2024, from 3.50% to 3.25%, and opened the door for a cut of 50 Bps at one of the two remaining meetings of the year. On September 26th, the Swiss National Bank (SNB) reduced its policy rate for the third time, from 1.25% to 1%, on the back of subdued domestic inflation and a strengthening Swiss Franc (CHF). Only 3 major global central banks that met during the month left interest rates unchanged; those include the Bank of England (BOE), the Norges Bank, Norway’s central bank, and the Bank of Japan (BOJ). In the US, yields declined sharply going into the FOMC meeting, however, in a textbook example of “buy the rumour, sell the news”, the 10 year yield closed the month 19 bps above the lows reached on September 17th, and 14 bps above the 2 year yield, ending the longest inversion of the US yield curve, which lasted 793 days. Credit spreads tightened to multi-year lows, with emerging markets and high yield the best performing segments. The Bloomberg Barclays Global Aggregate Index hedged back to AUD rose +1.07% for the month.

Australian Fixed Income

Domestic GDP grew +0.2% QoQ during the second quarter, while slowing to +1% YoY from an upwardly revised +1.3% YoY in the first quarter, the weakest annual pace since the 1990s recession, excluding the pandemic. State and federal government spending was a major contributor to economic activity. On September 5th, Governor Bullock gave her first annual keynote address at the Anika Foundation, titled “The Costs of High Inflation”. On that occasion, she reiterated the necessity of holding rates higher to avoid having to “slow the economy down by more, which would result in a larger rise in unemployment and higher risk of recession” should inflation become entrenched. She clarified that, while high interest rates are “hurting”, “it’s actually high inflation that is really causing trouble for people”. On September 24th, the RBA held the cash rate at 4.35% for the seventh consecutive meeting. Australian yields were mostly unchanged, with the 2, 5 and 10 year yield ending the month at 3.64%, 3.58% and 3.97% respectively. The Bloomberg AusBond Composite 0+ Yr was up +0.31% for the month, while the Australian Dollar appreciated vis-à-vis most major developed and emerging currencies.

Real Assets

Global property continued their ascent in September, rising +3.45% in USD terms and +0.75% in AUD terms. All regions gained, with Europe topping the list and Australia trailing the general index. Data Centres were the best performing sector, followed by healthcare, self-storage and office. Residential lagged, dragged lower by single family housing companies. Global infrastructure rallied +4.19% in USD terms and +1.47% in AUD terms for the month. The positive momentum in communications infrastructure persisted, while transportation stocks lagged. Electric utilities continued to benefit from the power demand of AI, with Constellation Energy and Microsoft signing a deal to reopen a nuclear reactor in Pennsylvania.

Alternatives

Alternatives (+0.87%) generated robust returns in September. Event Driven strategies and Long/Short equities managers led performance gains, while CTA and managed futures reversed four consecutive monthly declines.

Market Outlook

When the FED opted for a jumbo rate cut on September 18th, the so-called “recessionistas” interpreted its decision as the proof that the central bank was behind the curve, and that it should have kickstarted its easing cycle already in July. In their opinion, the fact that the US 10 year yield had fallen from a high of 4.74% on April 25th to a low of 3.60% on September 17th, that is, just one day ahead of the release of the FOMC meeting statement, was signalling that something was wrong with the economy. However, on October 4th, the Bureau of Labor Statistics (BLS) published a “blowout” jobs report, showing that Nonfarm Payrolls (NFP) had expanded by 254,000 in September, well above the 140,000 expected, and accelerating from a 159,000 increase in August. In addition, the unemployment rate ticked lower for the second consecutive month, from 4.2% to 4.1%, suggesting that the 0.5% increase observed between March and July may have been caused by a surge in labour supply rather than by the firing of employees (lower demand). The yield curve bear steepened, with the 10 year yield jumping to 4.23% at the time of the writing of this note (October 22nd). The so-called “inflationistas” took a victory lap, interpreting the sharp sell-off in bonds worldwide as proof that the FED should never have cut rates in September, let alone by 50 Bps.

The “recessionistas” take their cue from previous economic cycles where “financing” conditions were as restrictive as they are today, with real rates, that is, the difference between the FED target rate and the headline inflation number, 200-300 bps above the “neutral” level. Making it more difficult and more expensive for borrowers to obtain or renew a loan tends to disproportionately impact those who receive credit from the banking system and/or pay variable interest. In today’s environment, that would be primarily smaller companies, which happen to employ 50-60% of Americans. Conversely, the “inflationistas” look at “financial” conditions and note that they have remained extremely loose on the back of burgeoning government outlays and a bloated FED balance sheet. Such a benign, if not outright stimulative, fiscal-monetary mix has continued to support economic activity via direct transfers and via the wealth effect, that is, rich asset valuations. The tug of war between “financing” and “financial” conditions has (so far) produced the closest thing resembling a soft landing of the economy. In fact, every time signs of an economic slowdown have manifested, the long end of the yield curve has come down, loosening financial conditions and prompting an acceleration in GDP growth, in turn leading to a surge in the long end of the curve and a tightening of financial conditions. That dynamic has ultimately prevented the inflation rate from softening enough for the central bank to actually deliver an easing of its monetary policy for an extended period of time. But that has now changed.

Fast forward to today, the FED has declared that the war on inflation is over, and it has reverted to its “asymmetrically dovish” reaction function. Following a realignment in its priorities, it has fully committed to preserving and prolonging the economic expansion, relegating inflation risks to the backseat. In our opinion, its action and pronouncements have broken the sort of equilibrium that was underpinning the soft landing narrative. This is because the current economic cycle has been primarily driven by income growth rather than credit growth, given the looseness of “financial” conditions and the tightness of “financing” conditions. At last, the central bank has set the task, rightly in our view, of easing the latter to prevent unemployment from rising. However, its bold move has spectacularly backfired, with the bond market starting to discount the potential ramifications in terms of growth and inflation of a simultaneous loosening of “financial” and “financing” conditions. As a result, inflation expectations have quickly repriced higher, and that, coupled with Trump, who is assumed to be the most “inflationary” presidential candidate, regaining traction in battleground states, has prompted a (quiet) bond market rebellion. Yields have spiked and the US Dollar has strengthened, tightening “financial” conditions worldwide, the opposite of the outcome sought. We think that the central bank has bumped up against the limits of monetary policy in a fiscally dominant regime, and that it now finds itself in a conundrum. It must slow down the pace of rate reductions to stabilize “financial” conditions, but in so doing, it risks holding “financing” conditions too tight until it is too late.

To be fair, the US economy does not seem to necessitate monetary stimulus at present. In mid-October, GDPNow, the “nowcasting” model created by the Federal Reserve Bank of Atlanta to provide a running estimate of the real US GDP growth, was tracking at an annualized +3.4% for Q3, a notable increase from the +2.5% registered one month before, ahead of the rate cut. However, a note titled “A Better Way of Understanding the US Consumer: Decomposing Retail Spending by Household Income” published by the FED itself on October 11th, tells the tale of an increasingly bifurcated economy, one in which wealthier Americans keep spending while lower-income consumers are squeezed. Its conclusion is that “consumer resilience has been driven by middle- and high-income households” who “might experience a wealth effect as their homes and investments increase in value, while they also receive more interest and investment income during periods of higher interest rates, all providing a stimulus for sustained levels of spending”. That is consistent with the dichotomy between “financial” versus “financing” conditions detailed above. Moreover, an analysis produced by Bloomberg Economics posits that the strength in the labour market observed in September may be due to transitory factors. In fact, government hiring recorded its second largest monthly jump in history, as an “anomalous” 785,000 government jobs were added on a seasonally adjusted basis on the back of “outsize election spending”. In short, certain segments of the economy may remain in dire need of easing in the form of lower interest rates, but the FED may not be in a position to provide it fast enough.

In the first three weeks of October, the correlation between stocks and bonds have flipped back to negative, with the S&P 500 adding +1.60% over that period of time and the ICE US Treasury 20+ Year Bond, a popular benchmark to track the performance of long duration strategies, dropping -5.57%. A “flight to quality” has taken place in the equity space, prompting once again an extreme crowding into mega cap growth and the “Magnificent Seven”. The “American exceptionalism” theme appears to have regained steam, taking markets back to the “bubble” scenario, that is, the relentless outperformance of the S&P 500 caused by investors piling into US Big Tech in the belief that these behemoths will make money even if the FED remains restrictive. Although the risk/reward for equities going into the back end of the year seems less compelling to us, we do not see particular reasons to reduce our exposure to growth assets too far ahead of time. Our base case remains that of a “broadening” of the rally, with emerging markets well positioned to capitalize from a stable or softening US Dollar. However, given how late cycle the US economy is, it is conceivable that the “long and variable lags” of monetary policy may have done enough damage, keeping the probability of a recession elevated. Hence, we deem it prudent to maintain a fixed income exposure characterized by a duration comparable to that of the benchmark. Growth risks still outweigh inflation risks, and with the US CPI running below +3% YoY on a stable basis, the hedging quality of bonds makes a comeback. In addition, the carry remains attractive, and more so after the recent, significant boost. The macroeconomic backdrop remains uncertain, but we are convinced that the inauguration of the easing cycle put the “soft landing” not on the horizon, but in the rearview mirror.

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

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