Monthly Market Commentary with Portfolio Manager, Andrea Ciaccio

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Market Review

On December 18th, the FED lowered its target rate by 25 Bps for a cumulative 100 Bps of easing since the kick-off of its cutting cycle on September 18th. However, the dovish pivot on the part of the central bank has so far had the opposite effect on the US government yield curve, as interest rates have moved higher despite the reduction in cash rates. In fact, at the end of Q3, the 2-, 5- and 10-year yield equalled 3.64%, 3.56% and 3.78% respectively, while at the end of the year they had increased to 4.24%, 4.38% and 4.57%, that is, a 60-80 Bps jump across the board. That is in stark contrast to the decline in the FED target rate from a range of 5.25%-5.50% to a range of 4.25%-4.50% over the same period. Such behaviour is historically unusual. For example, back in 2019, the last time the central bank embarked on an easing cycle, the first 75 Bps of reduction were accompanied by lower interest rates. In fact, that year the FED brought its target rate from a range of 2.25%-2.50% to a range of 1.50%-1.75% between July 31st and October 30th, and the US government yield curve responded with a decline across the board of 30 Bps over the same period.

The sharp rise in US interest rates has also prompted a renewed rally in the value of the greenback. In the space of just three months, the Dollar Index (DXY) has rallied +7.65%, swinging from its lowest monthly close since March 2022 to its highest monthly close since September 2022. Over the same period, the Australian Dollar has crashed by -10.87%, its worst quarter since Q1 2020, at the onset of the pandemic. The sharp appreciation of the US Dollar may seem counterintuitive considering that the Reserve Bank of Australia (RBA) has maintained its cash rate unchanged at 4.35% throughout the whole year and that, following the cuts, the so-called EFFR, the effective federal funds rate calculated by the Federal Reserve Bank of New York, has converged to 4.33%, roughly the same level. In addition, the cost of hedging investments denominated in USD for Australian investors was only a few Bps at the end of 2024, after having been as high as 1.00% per year at the end of 2023, and 1.60% at the end of 2022. The differential in interest rates, rather than in cash rates or in the cost of hedging, appears 0to be the most likely cause; in fact, as the Australian government yield curve transposed higher by only 20-40 Bps in Q4, US Treasuries ended up offering a higher compensation for all maturities up to 25 years.

Several market commentators have posited that a dovish, activist FED and the election of Donald Trump have improved the outlook for economic growth in the US, prompting investors to unwind their recession hedges, that is, to liquidate their positions in long duration bonds. 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 first 50 Bps cut, was signalling that something was wrong with the economy. However, the central bank noticed the weakening trend and opted to “recalibrate” its policy stance in response, by shifting its focus from inflation to employment, thus preserving and prolonging the economic expansion. More positive news for the economy came shortly afterwards in the form of the nomination of Scott Bessent to serve as Treasury secretary in the second Trump 0administration; in fact, the billionaire hedge fund manager intends to boost US GDP growth to a steady 3%, a number consistent with a nominal GDP growth (that is, real GDP growth plus the rate of inflation) of 5%. Historically, the annualised nominal growth average over 10 years has demonstrated a good predictive accuracy in gauging the fair value of the 10-year yield.

Concerns around the outlook for the US fiscal situation have been making the rounds lately on the back of the large and skyrocketing size of the government deficits and debt. It is speculated that the US may be approaching a so-called “Liz Truss moment” on the back of a supply and demand imbalance developing in the Treasury markets. On the one hand, there is an estimated 9 trillion USD of public debt maturing over the next 12 months that will have to be refinanced. In addition, in the first two months of the fiscal year 2025 alone, the budget deficit has blown out to 624 billion USD, a +64% increase compared with the same period last year, and the Congressional Budget Office (CBO) is projecting that number to increase to just shy of 2 trillion USD by the end of September 2025. In short, Uncle Sam is on track to hit the bond market with 11-12 trillion USD in gross issuance, an all-time high in terms of supply. On the other hand, the share of total outstanding debt held by the FED, domestic commercial banks and foreign central banks have been falling in the last few years, with American households and institutional money, such as pension funds and insurance companies, picking up the slack. The latter buyers are highly sensitive to interest rates and may decide to go on strike should the FED persist in its easing push.

International Equities

While the jury is still out on whether the sudden and rapid repricing higher of the yield curve was due to “positive” or “negative” factors, or a combination of both, it exerted downward pressure on stock markets in December. The much-awaited Santa Claus rally failed to materialise and US equities fell for only the 3rd month out of 12 in 2024. The Dow Jones Industrial (-5.27% in USD terms) logged its 5th worst December in history and the Russell 2000 (-8.40%), the popular benchmark for smaller companies, gave back the outsized gains it generated in November almost entirely. The S&P 500 fared better, down -2.50%, and the Nasdaq 100 bucked the trend (+0.39%), as the “Magnificent Seven” continued their relentless ascent, leaving behind the rest of US large caps by a double-digit gap. All sectors except for consumer discretionary ended the month in the red, with materials, energy, real estate, industrials, utilities and healthcare suffering steep losses ranging from -6% to -11%. Conversely, communication services and technology held firmer; as a result, the MSCI World Growth recorded its 9th best monthly outperformance ever vis-à-vis the MSCI World Value Index.

US equities modestly underperformed the rest of the world (as exemplified by the MSCI AC World Index ex USA TR Index) in December. Japan ended the year on a high note, buoyed by a solid earnings outlook for large-cap exporters. China caught a bid on the back of Beijing’s announcement of “more proactive” fiscal policies and “moderately” looser monetary measures for the upcoming year. The explosive rallies in AI beneficiaries boosted Taiwan, but not South Korea, which grappled with political turmoil after martial law was imposed and then lifted hours later by President Yoon Suk Yeol. In Europe, the STOXX Europe Luxury 10 EUR TR which includes, among others, LVMH and Ferrari, rebounded strongly. All in all, the MSCI AC World Daily TR was down -2.37% in USD terms, but up +2.94% in AUD terms.

Despite the last-minute, minor setback, 2024 was another year of “American exceptionalism”, with the S&P 500 logging 57 new all-time highs and rising 20%+ for the second consecutive year, a feat it last achieved in 1997-98.

Australian Equities

Australian equities underperformed their international peers in December, as the MSCI Daily TR Net Australia Index recorded its 10th worst month ever vis-à-vis the MSCI AC World Daily TR. The S&P/ASX 300 dropped -3.08%, weighed down by materials, financials, technology and telecom companies. Consumer discretionary and healthcare held up better than the broader index, while consumer staples, industrials, utilities and energy bucked the trend. Returns were mixed at the stock level across sectors, as investors chose to lock in some profits in the highest performing names since the beginning of the year. The Top 20 outperformed mid-caps and smaller companies. Finally, growth stocks outperformed value stocks for the 4th month out of 12 in 2024.

International Fixed Income

Global central banks cut by a cumulative 175 Bps during the month, delivering the largest decrease in interest rates since the easing wave at the onset of the pandemic. On December 11th, the Bank of Canada (BOC) slashed its benchmark overnight rate by 50 Bps from 3.75% to 3.25%, its fifth consecutive reduction since June. One day later, the Swiss National Bank (SNB) reduced its policy rate for the fourth time by a larger than expected 50 Bps, from 1.00% to 0.50%. On the same day, the European Central Bank (ECB) lowered its policy interest rate for the fourth time, from 3.25% to 3.00%, and kept the door open to further easing. On December 18th, the FED administered its third consecutive reduction of the target rate but shifted toward a more hawkish stance. During the press conference, Chairman Powell made it clear that the central bank will adopt a more “cautious” approach going forward and that the timing and the magnitude of further cuts will be conditional to cooling inflation data. One day later, the Riksbank, Sweden’s central bank, cut its key policy rate by 25 Bps, from 2.75% to 2.50%, but seemed to suggest that it may “skip” the January meeting.

Among major global central banks that met during the month, the Norges Bank, Norway’s central bank, the Bank of England (BOE) and the Bank of Japan (BOJ) left interest rates unchanged. Across major emerging markets, the Central Bank of Brazil (BCB) hiked rates by 100 Bps to 12.25%, while the Central Bank of the Republic of Turkey (CBRT) slashed its policy rate by 250 Bps to 47.5%.

The Bloomberg Barclays Global Aggregate Index hedged back to AUD declined -0.86% for the month, as yields were generally higher across the globe, particularly at the long end. The ICE US Treasury 20+ Year Bond, a popular benchmark to track the performance of long duration strategies, dropped the most since April, down -6.16% in USD terms.

Australian Fixed Income

On December 9th, the Australian Prudential Regulation Authority (APRA) released a letter to the industry confirming its intention to replace AT1 Capital in the bank prudential framework with more reliable and effective forms of capital. On December 10th, the RBA held the cash rate at 4.35% for the ninth consecutive meeting and signalled increased confidence that inflation is moving sustainably towards the target range of 2% to 3%. Following the dovish pivot, the cash futures moved to push back to Q1 2025 the first cut. The Bloomberg AusBond Composite 0+ Yr added +0.51% for the month as the Australian yield bull steepened, with the 2- and 5-year yield declining 9 Bps and 5 Bps to 3.86% and 3.92% respectively and the 10-year yield rising 2 Bps to 4.36%. The Australian Dollar weakened across the board, plunging vis-à-vis the greenback to its lowest level since March 2020.

Real Assets

Global property lost 7.28% in USD terms and returned -2.23% in AUD terms in December on the back of tightening financial conditions. Asia was the only region to marginally outperform the general index, while Australia exhibited the most dramatic decline. All sectors fell.

Global infrastructure declined by 4.75% in USD terms, but was slightly positive in AUD terms (+0.44%) for the month. Transportation stocks outperformed owing to the resilience of airports and toll roads and despite the poor returns generated by railroads. Conversely, utilities and communication infrastructure lagged.

Alternatives

Returns for Alternatives (-0.01%) were unchanged across strategic mandates in December, with performance dispersion narrowing during the month. Fixed Income and Relative Value strategies posted gains, while Long/Short equities pared YTD gains.

Market Outlook

Stephen Miran was recently picked by Trump to lead the Council of Economic Advisers, a panel of experts tasked to provide the president with advice on domestic and international economic policy. Shortly before being nominated, the American economist and senior strategist at a well-known hedge fund published an insightful research note titled “A user’s guide to restructuring the global trading system” in which he lists some of the tools that the new administration could make use of to “put American industry on fairer ground vis-à-vis the rest of the world”. To set the stage, Miran observes that America makes reserve assets, that is, the US Dollar and Treasuries, available to the rest of the world, and that facilitates global growth and provides a vehicle for large pools of savings. The US Dollar is the “lifeblood of global trade and financial systems” as “America provides stability, liquidity, market depth and the rule of law”. That arrangement allows America to project financial power (for example, it can use sanctions to weaken enemies

"without having to mobilise a single soldier"), but leads to a structurally overvalued greenback, making US exports less competitive and causing the loss of domestic manufacturing jobs, with all the socioeconomic problems that it entails. With the US share of global GDP having halved from 40% in the 1960s to its present level of 26%, the economic cost for America has grown over time, and now the global hegemon "finds it more difficult to underwrite global security". In fact, it must continue to import more than what it exports, that is, run a trade deficit, but in doing so, its ability to produce equipment has been increasingly hollowed out. Here lies the key insight: according to Miran (and presumably to Trump), America provides a "global defence shield to liberal democracies" and, in exchange, it receives the benefits of reserve status. As a result, "the defence umbrella" and the "trade deficits are linked, through the currency", and that relationship is increasingly straining America's resources.

Tariffs offer a path to address the economic imbalance and to prevent other nations from "taking advantage of America". They were extensively used, "with success", in the 2018-2019 trade negotiations with China, in that they were not inflationary and raised revenues for the US government from trading partners, albeit to a limited extent. Back then, the effective tariff rate on Chinese imports increased by 17.9% "from the start of the trade war in 2018 to the maximum tariff rate in 2019". The Chinese Renminbi depreciated by -13.7% over the same period, "so that the after-tariff USD import price rose by 4.1%". "In other words, the currency move offset more than three-fourths of the tariff, explaining the negligible upward pressure on inflation". Ultimately, the purchasing power of American consumers was not affected, while the citizens of China became poorer as their real wealth and purchasing power declined on the back of their currency depreciating. That is the main reason why Miran concludes that "tariffs are USD-positive" and may lead to a strengthening of the greenback. In his view, tariffs present an interesting trade-off between revenues on the one hand and a repatriation of economic activities from the rest of the world on the other hand. Crucially, either outcome is positive for America. In fact, "if currencies perfectly adjust, the US government collects revenue in a non-inflationary way paid by foreigners via reduced purchasing power". Trade is not reallocated to the US, but, as "tariffs are ultimately financed by the tariffed nation", US policymakers can reduce the adverse consequences on exports by reducing taxes and/or pursuing an aggressive deregulatory agenda. In that scenario, the spread between the market value and the fair value of the greenback persists, but there is "improved burden sharing in the form of subsidisation of the US taxpayer by reserve holders". "By contrast, if currency offset does not occur, American consumers will suffer higher prices, and the tariff will be borne by them. Higher prices will, over time, incentivise a reconfiguration of supply chains. American producers will have improved competitiveness" and "as trade flows adjust, the trade balance can decline".

While Miran's logic is impeccable, we contend that it may not be applicable in the context of a "Trump 2.0" administration. Conditions today are vastly different from 2017, when he was first inaugurated. Back then, according to the data published by the US Bureau of Economic Analysis (BEA), the US net international investment position (NIIP) was equal to a negative 8.32 trillion USD, which translated to 43.26% of US GDP. In plain English, the stock of American assets owned by foreigners (32.17 trillion USD) was higher than the stock of foreign assets owned by Americans (23.85 trillion of USD), making the US a "debtor" nation. Fast forward to the end of Q3 2024, that number had almost tripled to 23.60 trillion USD, that is, 80.34% of US GDP. The stock of American assets owned by foreigners (61.46 trillion USD) had grown much faster than the stock of foreign assets owned by Americans (37.86 trillion of USD) on the back of the American "exceptionalism". Intuitively that makes sense as, not only US assets have massively outperformed the RoW assets over the same period, but capital has continued to flow into the country from abroad on the back of more attractive investment opportunities, primarily in the technology space (think "Magnificent Seven"), superior economic growth (since 2020) and higher interest rates (since 2022), sustaining the value of the US Dollar. As a result, international investors, public and private, have never held such a large overweight exposure to US assets and, on top of that, they are sitting on enormous, unrealised profits. Our concern is that, should Trump proceed with his plan of enacting universal tariffs, they may have to start to sell and repatriate part of that huge pile of holdings to defend their currencies and cushion their economies from the harmful effects detailed above. In short, we see a tangible risk that the "currency offset" scenario may play out differently this time, with the rising value of the USD potentially affecting global financial stability.

That dynamic may already be taking place, and rising US yields may well be the collateral damage of a too strong USD, that is, the correlation between those two variables may be going the other way around from what is commonly assumed. In fact, as the greenback appreciates in anticipation of the upcoming tariffs, the economies of the rest of the world weaken, Treasuries get liquidated, yields rise, and the demand for USD increases, putting further upward pressure on the value of the currency. In his paper, even Miran notes, in passing, that, "there is a contemporaneous negative correlation between the exchange value of the dollar and the level of global reserves. Reserves tend to go up when the dollar is going down […] and vice versa when the dollar is going up". If reserves are going down because the USD is going up, that is, if foreigners are selling Treasuries, and that is leading to higher yields, then the American "exceptionalism" may have reached its limit. In fact, given its high degree of financialisation, the US economy appears to be more sensitive to movements in long term yields, rather than in cash rates, and any tightening of financial conditions such as the one that has just occurred tends to flow through to consumers pretty quickly via the so-called "wealth effect". For that reason, we continue to think that the risks to economic growth outweigh the risk of an inflation revival going into the first half of 2025. We see an increased probability of the macroeconomic backdrop evolving from one of a re-acceleration of the economy to a "growth scare" following the spike in the USD and the rout in bond markets. At its last FOMC meeting, the FED spooked investors by pivoting hawkish, but, if our thesis is correct, in 2025 it may end up having to cut by the 100 Bps it was projecting at the end of September. As a result, we remain comfortable maintaining a fixed income exposure characterised by a duration comparable to that of the benchmark. In 1971, US Treasury Secretary John Connally famously remarked that "the dollar is our currency, but it is your problem"; more than 50 years later, the "strong dollar policy" may have become a problem for everyone, including the US.

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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