AEQUITAS INVESTMENT PARTNERS

2024 Outlook

Summary

- ***Soft landing* continues.** Both stocks and bonds do well, but outcomes vary by geography (harder landings for Australia, New Zealand, and Canada). Bonds have more chance of outperforming expectations than stocks.
- **Both credit and government bonds** should perform well as defaults remain low and rates decline. However, sub-investment grade will see higher defaults and thus *a lower realised* excess bond premium.
- **Commodities** will be highly volatile as we drift between "soft landing" and "hard landing" narratives, iron ore will weaken as Chinese steel production declines; the long-awaited *lithium bounce* never comes.
- **Property and infrastructure** recover from the 2023 sell-off as earnings grow via rent reviews or regulatory resets.
- **House prices will decline**, but they will vary in magnitude by geography, with larger falls in Australia, New Zealand and Canada, where mortgage debt is higher, valuations dearer, and the proportion of variable rate mortgages greater.
- **Alternatives** (hedge funds, private equity, private debt) will prove less attractive given that vastly higher bond yields reduce the need for complexity because traditional asset classes have been repriced.
- **US dollar will moderate** from presently *very high levels* against most currencies. However, the AUD will remain comfortably below $0.70c *on average* as it continues to price tail recession risks. **Euro will likewise weaken**, given a weak economy and the prospect of recession brought on by tight monetary policy.
- **Cash will remain attractive**, given the highest yields on offer in many years. However, we prefer fixed income to cash, given our expectation that cash rates will drop as inflation cools and policy shifts to a less restrictive stance.
- **Defensive stocks**, should table a stronger performance over 2024, having underperformed over 2022-2023, as they "digest" higher rates and benefit from a "flight to quality" as and when bumps in the road emerge over the year ahead.

The market will vacillate between the *bullish narrative* of: "rate cuts are coming because inflation is defeated" and the *bearish narrative* of "rate cuts are coming because the US Federal Reserve is behind the curve and the economy is at stall speed". In other words, 100-150bps of cuts make everyone feel good; more than 150bps of cuts in a single year will probably cause panic stations because it would imply "something broke". The bullish interpretation was supported by what has now become widely regarded as the shift in Fed rhetoric, as evidenced by this speech from Governor Waller, quoted below.

If you see this [lower] inflation continuing for several more months, I don't know how long that might be—3 months? 4 months? 5 months? —you could then start lowering the policy rate because inflation's lower."

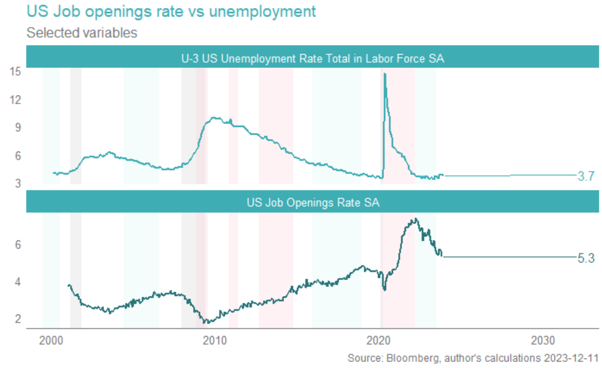
Federal Reserve Governor Chris Waller

And, given that things are rarely so straightforward, there will be moments where the market *prices out* cuts, likely whenever data prints with unexpected strength (inflation, jobs, production etc). But the good news is that this last point is less likely from here, and overall, with inflation and output growth at trend we should expect more than 200 basis points worth of rate relief over the next few years.

More detail is below.

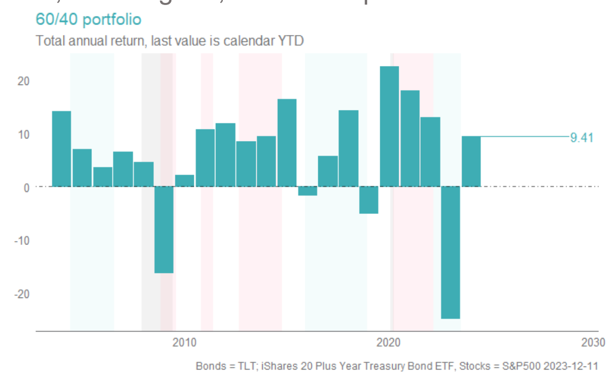
2023 highlights

Unemployment
The major theme of 2023 was that taming inflation didn't require a massive uplift in unemployment.



Employment has (so far) remained robust.

60/40 portfolio
The other central narrative was the death of the 60/40 portfolio – which has had a decent enough year. Perhaps that is modest consolation given 2022 was bad, but relative to a narrative of "it's all over, never again", 2023 was quite a bit better.



Risk-adjusted returns
As for the role of bonds, the "holy grail" of investing is to find the highest return per unit of risk. That is the "efficient" portfolio in risk-adjusted returns. The 60/40 portfolio *still has it* (highest Sharpe ratio). Diversified investment portfolios (i.e. ones with bonds, as well as all the other asset classes) remain preferable to "100% equities".

	Annualized Return	Annualized Risk	Sharpe ratio
Bonds	0.35	13.77	2.51
Stocks	7.28	15.17	47.98
60/40	5.04	10.03	50.30

Source: Bloomberg, author's calculations 2023-12-11

Diversification: your only free lunch
An important side note; bond yields have lifted over the past 18 months, such that *even government bonds* are yielding above 4%. Given that stocks and bonds typically have negative correlations (if inflation is well-behaved), adding bonds to one's portfolio is a sensible strategy. And there's good reason to expect *that the correlation stays negative as long as inflation is anchored below 3%.*
Many may tell you: "Don't bother with bonds, just hold stocks for the long run". Given **a)** the currently attractive yields on offer in fixed income, **b)** the expectation that inflation returns to 2-3% target and **c)** that the usual low to negative correlation will return, bonds are a compelling part of the overall portfolio.

2023: The winners
Growth stocks were the major winners, as AI hype, chat-GPT enthusiasm, and a "soft landing pivot narrative" bolstered already strong earnings growth from stocks like NVIDIA, Microsoft, Amazon and Google.
Gold performed well as markets searched for assets differentiated from stocks and bonds and had idiosyncratic drivers (like central bank buying).

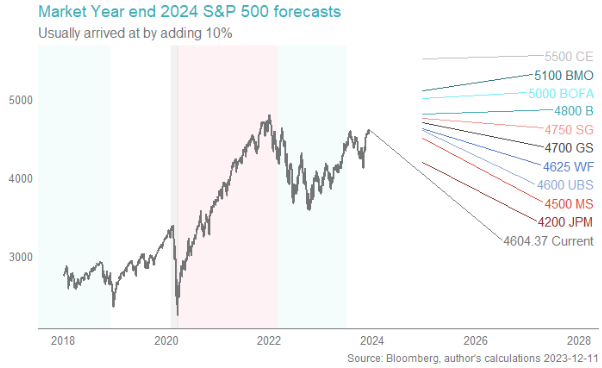
2023: The losers
Commodities, the champion of 2022, gave a lot of that back, with nearly every commodity except iron ore succumbing to higher interest rates, which (at the margin) weaken the demand for investment and, therefore, construction-related materials. Oil was also driven by market specific concerns, such as the expanding US oil production story and the gradually dissolving market power of the OPEC cartel as a swing producer.

Property (A-REITs, G-REITs) and Infrastructure have flat to negative returns over the 1, 3 and 5 year periods. We expect the outlook to be much stronger over the next 1, 3 and 5 years, which we discuss later, a more constructive view.

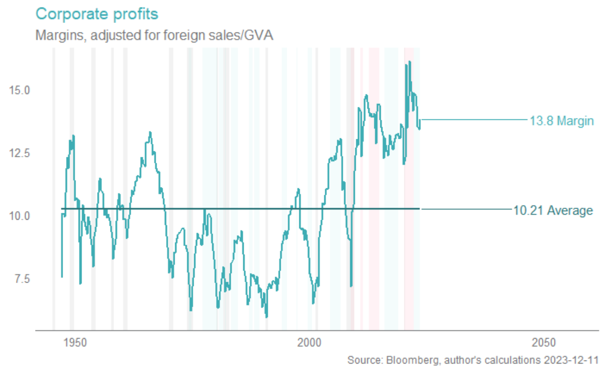
In general, on a Dynamic Asset Allocation basis, we will usually look for the worst performing asset classes for ideas for incremental capital deployment. The market tends to assume *"things are bad now and will always be bad forever".* Instead, **things tend to recover, and motivated participants figure out how to solve problems. Betting on human ingenuity and (where appropriate!) optimism is a big part of a successful investment process.**

2024 the detail

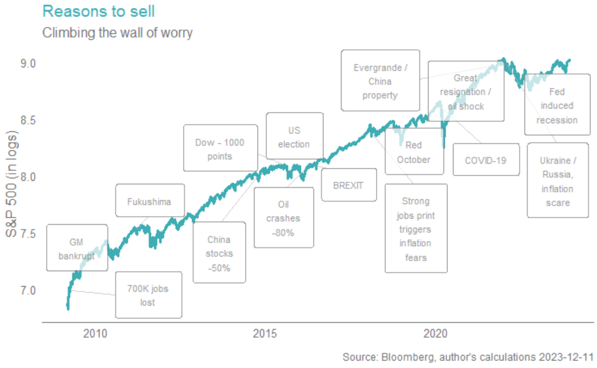
The *market's outlook* is a function of its participants' views. Most published outlooks are usually "dead in the water" by March and look embarrassing to all by May. The earlier the release of the outlook, the quicker this obsolescence arrives. That said, this year, there are some "spicy takes" from "the street", with JPMorgan particularly bearish (taking over from Mike Wilson of Morgan Stanley as "chief bear") and Capital Economics particularly bullish.



There are only two variables usually tabled in the outlooks, "where to" for 2024 equity earnings per share (EPS) and "what is the appropriate multiple to pay for those earnings". For example, "I think 2024 earnings will be $300, and I think paying 15x forward earnings (i.e. the longer run average) will deliver my 4500 price target". The macro variables used to flavour those outlooks are corporate profit margins, GDP growth, interest rates and foreign exchange movements. You might decide that the below "regime change" in corporate profitability won't hold (margins will get eaten up by wage gains, perhaps), and thus, your EPS target is well below that of the market.



Now, we tend to resist the urge to put a number on the market over such a short time frame, mainly because we don't know where it (in the case above, the S&P 500, arguably the most important stock market on Earth) will wind up. The key to our market outlook is to recognise that the price targets are a fool's errand. However, we provide *the actually useful bit*, which is the weights of the portfolio itself, and those weights in turn reflect all of our preferences and expectations about the short, medium and longer-run direction of capital markets. The other helpful bit is to provide our views on directionality, e.g. "We think X will likely outperform Y, and thus, we have more of X and less of Y based on those relativities". And, of course, lurking in the background is our usual view: that ***time in the market*** **matters much more than** ***market timing*** and allowing capital to compound slowly over long periods is the most efficient way to grow wealth, as the market climbs the wall of worry.



The “shopping list” of things we think will and won’t happen

- We will get *at least one* negative non-farm payrolls print in the US (e.g. job losses in a month), and the equity market will freak out. That likely means an *intra-year drawdown* of at least 10%.
- We will get *at least one* surprise 20-30 basis points print (e.g. change in a month) move in the unemployment rate. That would also likely trigger an **intra-year equity drawdown.**
- There will be more **bankruptcies in the Commercial Real Estate** space, noting WeWork’s bankruptcy during the year and real estate deal flow collapsing. We can expect material intraday moves in Real Estate Investment Trusts and bond yields when they come.
- **Oil will fall** to $50 on recession fears (perhaps driven by that forecast negative Non-Farm Payroll numbers) at some point during the year, causing many to “bring forward” forecasts for the early demise of most oil and gas companies. This is more of a left-tail scenario, but should it occur it would be an excellent time to increase one’s Oil and Gas exposures.
- **Gold will fall** back below $2000/oz.
- **Electricity prices will spike** well above $100MWh as bumps from the energy transition meet difficult-to-forecast weather conditions.

Note we don’t have any “deep left field items” in the outlook, either, like

- China moves on Taiwan.
- A broader Middle Eastern conflict.
- An omicron COVID variant rears its head and puts us all back into lockdown.

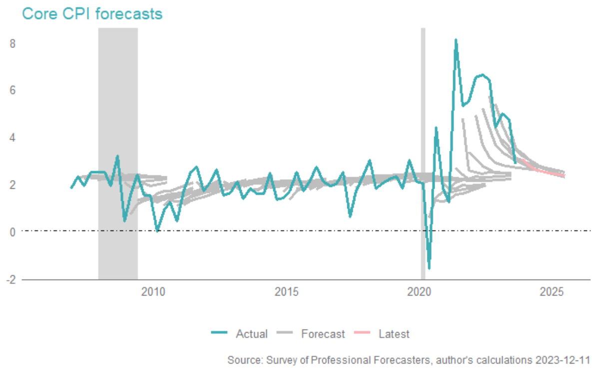
However, the *possibilities* exist, and we reflect those in various ways. For example, we have emerging market equities in the portfolio *because we think they are cheap*, but at the same time, we are underweight China within those exposures because the possibility of military conflict is non-zero. We also cap the overall exposure at low single digits to help mitigate the risk.

It is the same conceptual approach with Omicron (or some other nasty pathogen); a) **we tend to invest in companies with stronger balance sheets that can withstand unexpected lockdowns** and b) specific hedges through holdings in individual stocks like ResMed, CSL, and Sonic, all of which would likely benefit should such an issue arise again (and, like war, it seems that **pandemics are more elevated as a baseline probability** than perhaps society appreciated in the past).

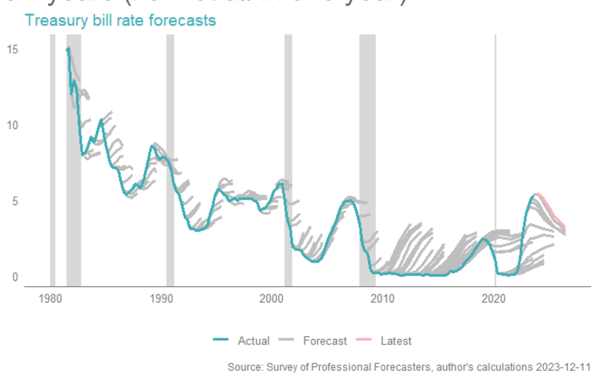
To varying degrees, oil and gas exposures in equity portfolios act to hedge out the risk of an accurate shortage in a critical raw material input.

Macro factors

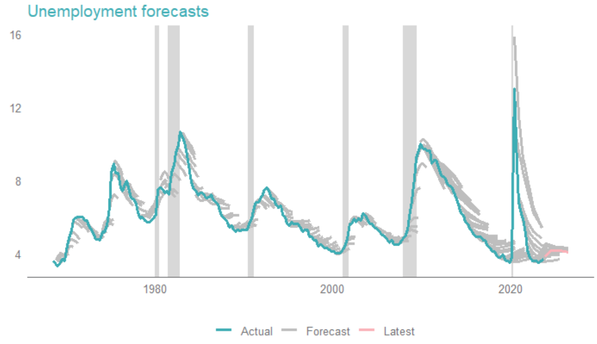
Inflation returns to target. We have always thought this, believing the power of central banks to be 100% able to tame inflation. The progress on inflation has been excellent, and we will likely return to the 2% target by April 2024



This means that **US interest rates can be cut by *at least 150-200* basis points** (e.g. from ~5.50% to 3.5% at the low end) over the next few years (i.e. not all in one year).

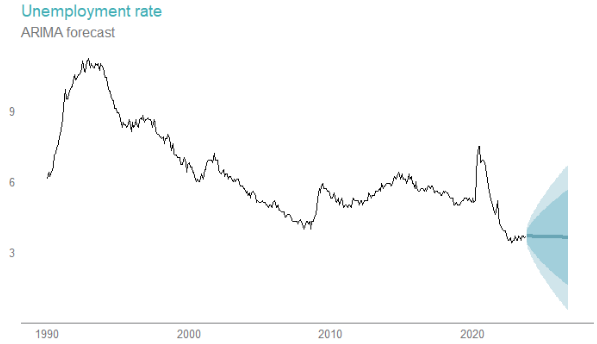


As such a “mega bid for bonds” is possible. Note also if we “overshoot” to the downside, perhaps because of a negative jobs print, the market will price the probability of recession quite quickly, and in recessions, the cash rate has usually been cut by 500 basis points, *on average*. Unemployment should rise, and in the US will likely climb to the mid 4% range.



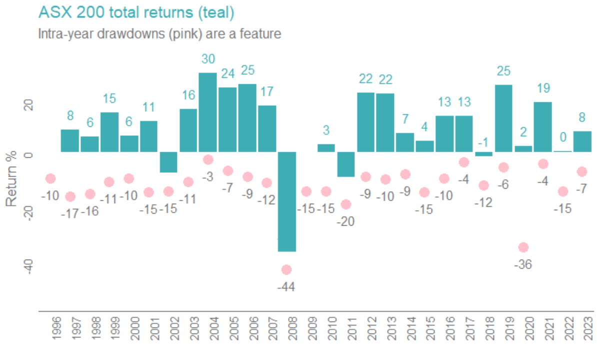
Source: Survey of Professional Forecasters, author's calculations 2023-12-11

We see this as very distinct from Australia, where the market expects unemployment to hold at largely similar values to the recent past. In contrast, we see the upper bands of the below confidence interval range are more likely (e.g., rising to above 5%).



Source: Bloomberg, author's calculations 2023-12-11

On the intra-year equity drawdowns, *which will happen* when some piece of new, unexpected bad news drops, it's worth keeping in mind that intra-year drawdowns are the very reason we accrue such a large return to shares in the first place. If a strategy was easy to follow and easy to stick with, *everyone would*, and there'd be no outsized equity risk premia to collect in the first place.



Source: Bloomberg,author's calculations 2023-12-11

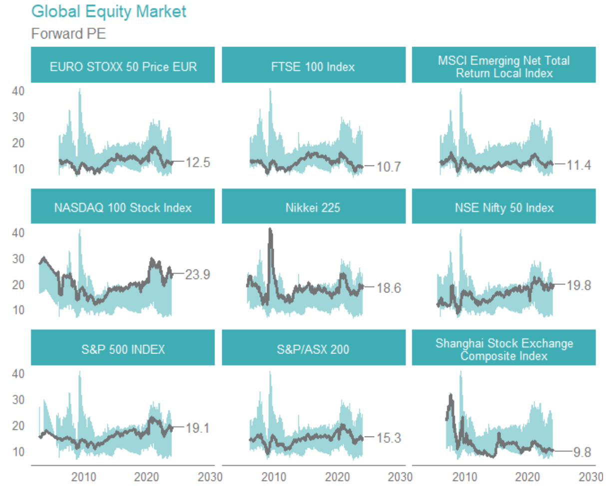
Equities

International over domestic, ex-US over US, emerging market over developed.

Our general view on equities is that **international equities will outperform Australian equities**, with the Aussie share market struggling, given a weaker consumer due to higher mortgage servicing costs.

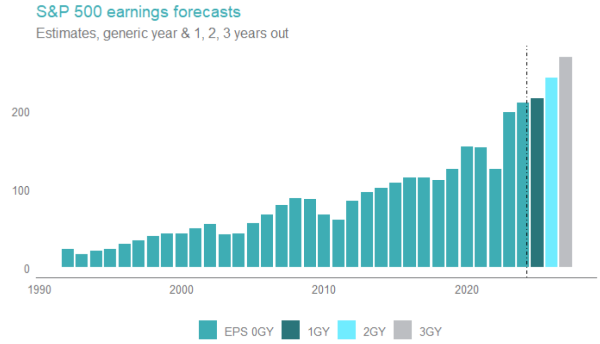
Many international markets are cheaper (below, forward Price/Earnings ratios) and have greater diversification than the local market (less reliant on cyclical banks and commodity stocks).

European and UK equities offer a roughly 8-10% earnings yield, which looks particularly attractive compared to US equities, and we note that the emerging markets remain very depressed due to China's wobbles and the stronger US dollar. As both normalise, the emerging world can generate attractive returns.



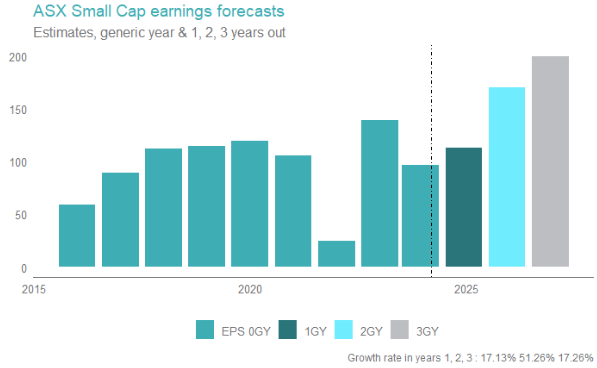
Source: Bloomberg, author's calculations 2023-12-11

The forecast EPS growth rate for US equities looks *too optimistic*. If nominal GDP growth is to slow, *such that we have a soft landing,* we can't see how US equities grow earnings by over 20% in 2024 and 2025 (the compounding of 12.33% and 10.93%, see caption below).

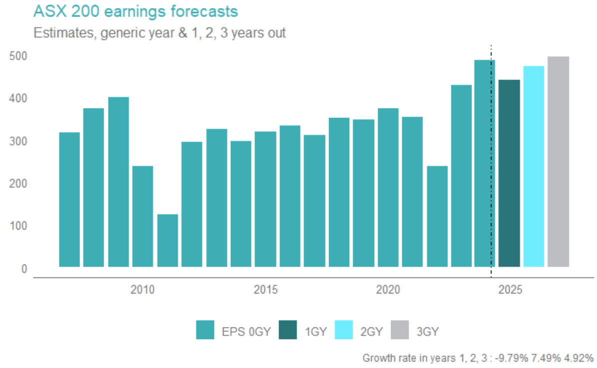


Growth rate in years 1, 2, 3 : 2.91% 12.33% 10.93%

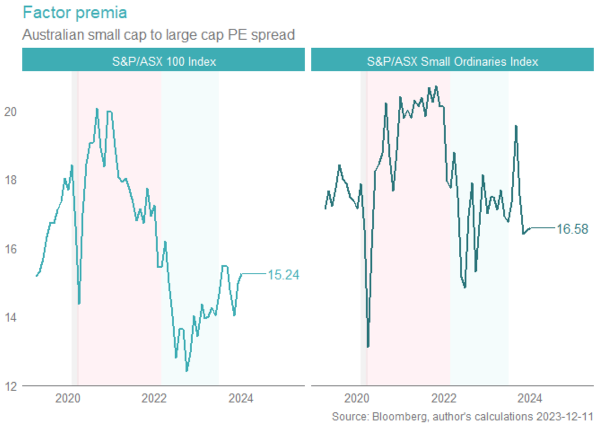
Small cap to outperform large cap
The forward earnings growth estimates for small-cap are roughly 2-3x that of large cap. Below is the ASX small universe…



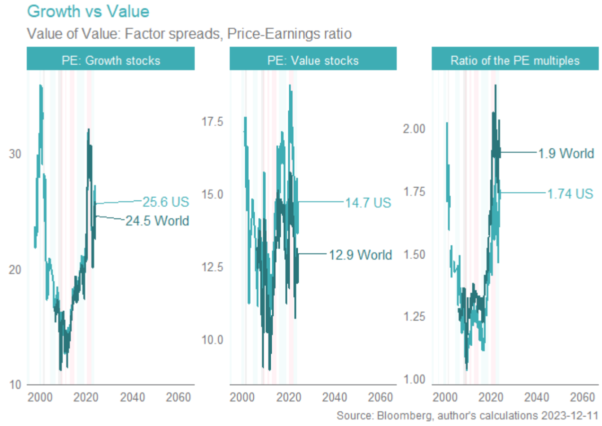
…versus the ASX 200. There is a tremendous disconnect in assumed forward earnings.



Normally, such an earnings gap would equate to a valuation gap (all else equal, faster growth means a higher PE multiple). However, here, we see broadly similar valuation multiples (~15x vs ~16x times). The valuation gap opened because of the high interest rate and high inflation environment, and **we expect small companies to outperform** as both normalise.



Value equities to outperform growth equities
Value stocks are trading at a near record discount to growth stocks (see below, 12.9x for value stocks in the MSCI World Value index, vs 24.5x for the growth index, a ratio of ~1.75x, and at a level on par with that of the tech bubble). Far too much mania and exuberance is priced into the "Magnificent 7", which we think will lead to earnings disappointment and, therefore, sub-par returns to growth strategies.



Property
Occupancy rates remain relatively high (across hotels, retail, social assets like stadiums, daycare centres and the like), with growing rents (albeit slowly) and support from longer-dated interest rates coming down from 5% to 4%.

With the near lone exception of Goodman group, the discount to Net Tangible Assets or Net Asset Value is on par or exceeds that of the Global Financial Crisis. Commercial real estate values could fall by over 25% and still be compelling on valuation grounds.

However, not all the names will survive. Several are very highly geared, approaching covenant limits, and as debt hedges roll off, they will have to either sell assets, raise capital or go under.

Commodities
Most commodities behaved like excellent inflation hedges during the great supply shortage of 2022. However, as supply chains healed, goods demand normalised. Interest rates also went up, causing marginal demand to come down, so commodities underperformed. There is idiosyncratic variation in every market. Aluminium is in oversupply thanks to China's production, so too for steel.
Natural gas demand varies with weather, and the trend for warmer winters has continued. Oil is vulnerable to a slowdown in global demand (of all commodities, perhaps oil is the most acutely sensitive to any slowdown in economic activity).

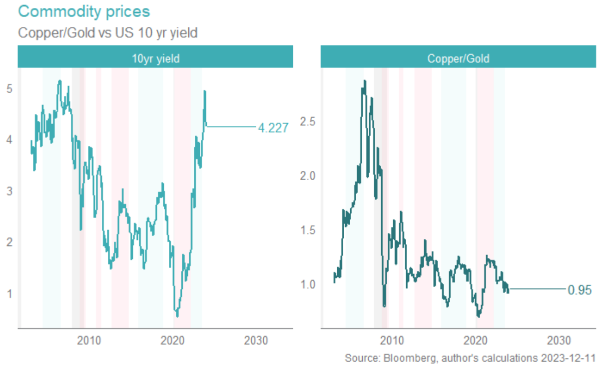
Lithium/nickel/cobalt/manganese
We see these metals as "victims of their own success". Cobalt's ESG issues (child mining) and supply side squeezes (batteries required lots, and cost lots) led to disintermediation.
Nickel saw much the same thing (at one stage nickel reached 85% in NCM cathodes).
Now it is lithium's turn, as sky-high prices led to more exploration, which turned up many more reserves and also led to the focus on **sodium-ion batteries, which we think will replace lithium as the longer term winner.**
That means the current 6% spodumene price likely goes back toward the 30 year average (well below $1,000).

Oil
Despite two wars, OPEC cuts, and an ongoing pandemic recovery, oil has struggled.
In part, this is because each time OPEC cuts, US production expands.
However, the long and gradual decline in oil consumption (the long plateau) means that the lowest-cost producers will probably do okay, and overall, we expect the price to sit between $50 and $80 across 2024.
We think that **the transition away from coal (i.e. natural gas, LNG as a bridging fuel)** means that *for 2024*, we don't need to price out LNG producers into terminal decline.
To be clear, our long run view is negative, but we don't think 2024 will be bad *for all producers (*the Occidentals, Chevrons, and Woodsides of the world will be okay *for at least another year*), and if volatility spikes (due to say a war between the OPEC members regarding compliance) we would happily lift our exposures.

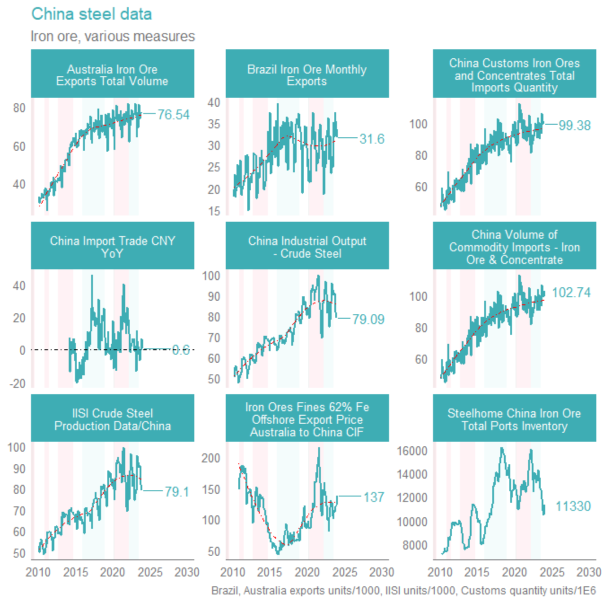
Gold
We think gold will struggle to stay above $2,000/oz. As inflation behaves, that will rob gold investors of a key reason to be long. Similarly, we think central bank buying (which has kept gold demand elevated) will moderate once they reach their "desired balances" (red dotted lines depict high inflation periods).

However, we think gold is/will be a useful portfolio diversifier in general, and we are not as dogmatic on the "no need for gold" idea as we used to be. There are also listed gold companies trading at attractive valuations, so there's a case to be made at both the multi-asset level and within stock selection in equities.

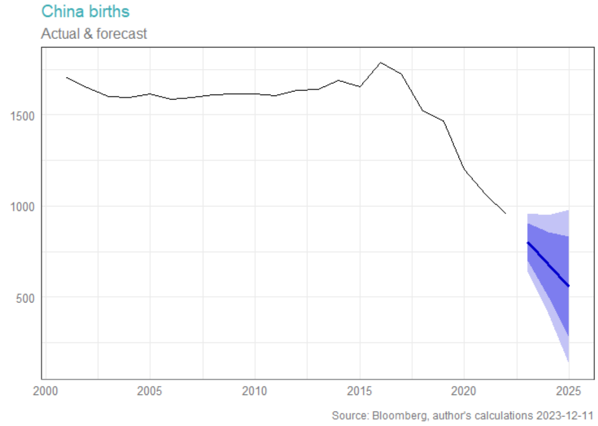
As a side note, the copper/gold relationship supports the idea that either longer dated treasuries are mispriced (so yields lower) or copper is cheap relative to gold (gold overvalued).



Iron ore
China's robust steel production has continued to surprise us. We had thought, given a property sector collapse and low Chinese steel mill profitability, that China's demand would fall.
It has not. Indeed, inventories are low (bottom right). However, it is very possible that China is dumping steel (excess steel supply) onto global markets and would invite a trade response from the EU and the US, amongst others. This reaction is a tail risk to iron ore prices over 2024.

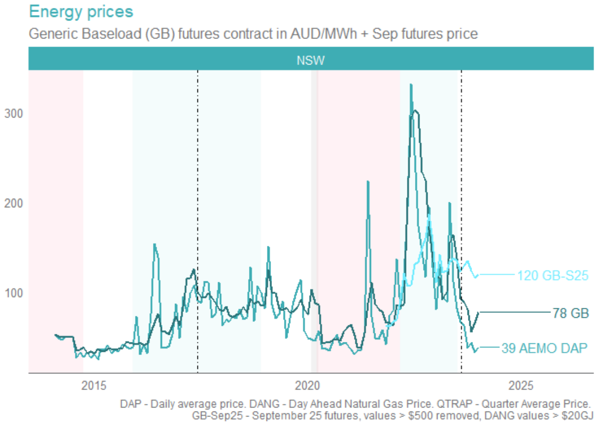


More generally, China's adverse demographics (a function of the one child policy) will mean less commodity demand over the coming years.



Electricity

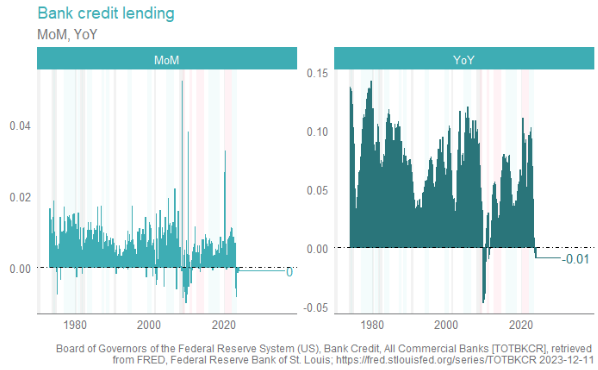
As coal-fired generation is switched off, and electricity demand (hot summers, electric vehicle charging stations, smart homes, heat pumps, the rise of AI and data centres) rises, we see the odds of dislocations (periods of extremely high wholesale prices) rising.



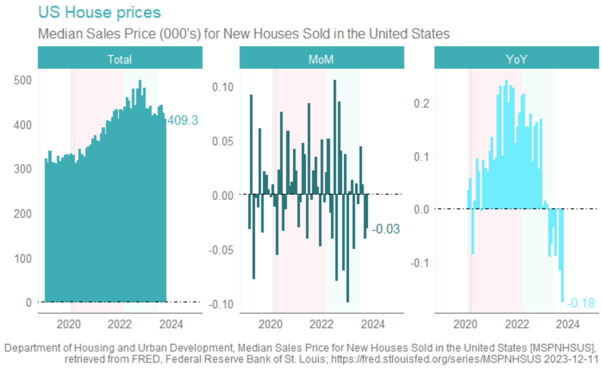
We attempt to hedge some of that tail risk through a) infrastructure exposures and b) utilities.

Housing

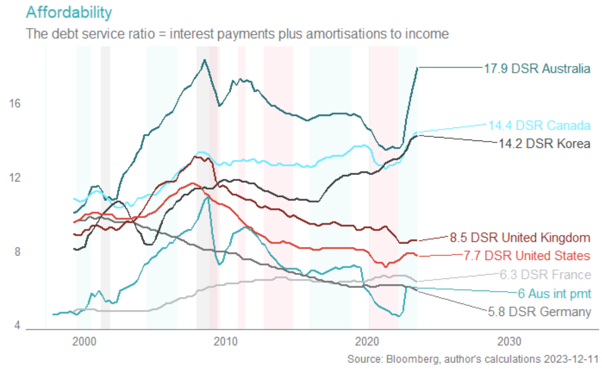
Usually, the flow of credit guides any short run opinion on housing. Below, we can see US credit lending drying up.



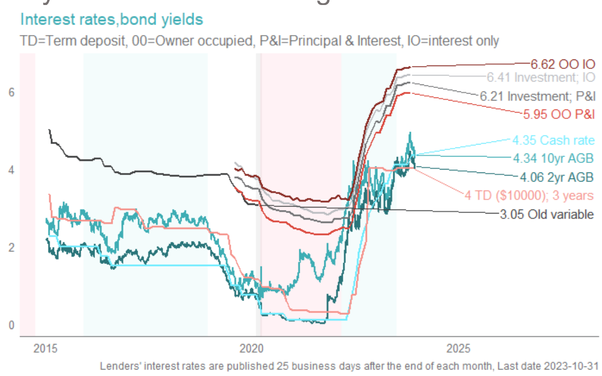
And so, it isn't a surprise to see new home sales prices rolling over. This isn't quite as dire as it looks. Firstly, higher rates mean homebuilders have offered *smaller homes*, so it is literally "less home" instead of "these are worth less today than last year".



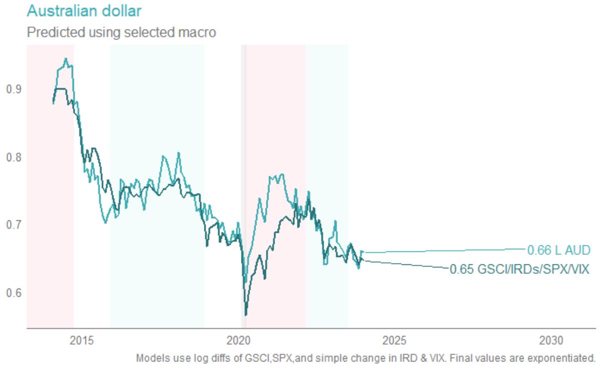
For countries like Canada or Australia, we see pressure as a function of debt servicing ratios, which have climbed sharply over the last 18 months. This decline in affordability and servicing ability will weigh on house prices in the order of 10-15%.



We think that's quite a bit, and for households who have taken out "too much debt", the need to cut back on consumption makes us nervous about the outlook for the economy as a whole and the stock market in particular. Those mortgage rates will come down, but not until they've done some damage first.



Foreign exchange
The AUD relative to the USD is broadly fair value.



If commodity prices rally strongly (global growth stays buoyant or accelerates from here), the AUD will likely move through 70c, and we would see that as an excellent occasion to increase one's *unhedged exposure* (meaning to benefit from a falling AUD). Were it to fall below 60c on growth concerns, that would be an excellent opportunity to increase one's hedged exposure within international equities.

AUD/EUR
The Euro, however, looks a little too strong relative to the AUD. The economic footings of Europe are just as shaky (if not more so) than they are for Australia, and the odds of **Germany and France leading the rest of Europe into a rates induced recession** are high.
That would mean the rates differential moves in Australia's favour, which would be consistent with a stronger AUD relative to the EUR.

We are quite **attracted to EU equities** and are hoping for better pricing across 2024.

Fixed income
The attraction to credit and government bonds is quite straightforward. US investment grade credit is yielding over 6%, with observed cumulative default rates well below 1%, and Australian investment grade credit (BBB 5yr yields) are close to 6%, where the observed default rate is likewise very small.

The below indicates how low those defaults have historically been and how high the recovery rates have been, such that the expected loss is small and loss in any given year still smaller.
Note we tend to avoid the sub-investment grade pocket of the market.