ASSET MANAGEMENT

Something's gotta give, redux

Anthony Golowenko, Senior Portfolio Manager

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Around two years ago, I gave the *Something's gotta give* title to an article. Two years on, it seems appropriate again, so I thought I'd give it a re-run as we seem to be at another economic and market inflection point. Central bank policies feature in this narrative, as they did then.

That said, market participants' reactions to interest rate cuts, earlier this year, by the likes of the European Central Bank, the Bank of Canada, and the Bank of England, were of the shrug-of-the-shoulder variety, as the US Federal Reserve (the Fed) remains the main game.

Investors who had been clamouring for the Fed to join its rate cutting peers finally got their wishes fulfilled when the world's most closely watched central bank recently cut policy rates by a greater than expected 50 basis points.

You might think happy days are here again, for financial markets. Err, not quite. There are a few complications and cautionary flags.

Rates cuts don't always turnaround hostile economic trends

Here's a sobering fact: the Fed cut policy rates by 100 basis points in the months leading up to the 2001 recession, and the 2008/09 Global Financial Crisis. In those instances, rates cut were unable to turnaround deeper, economically hostile trends already underway.

Is there a risk of history repeating itself? Yes, with qualifications.

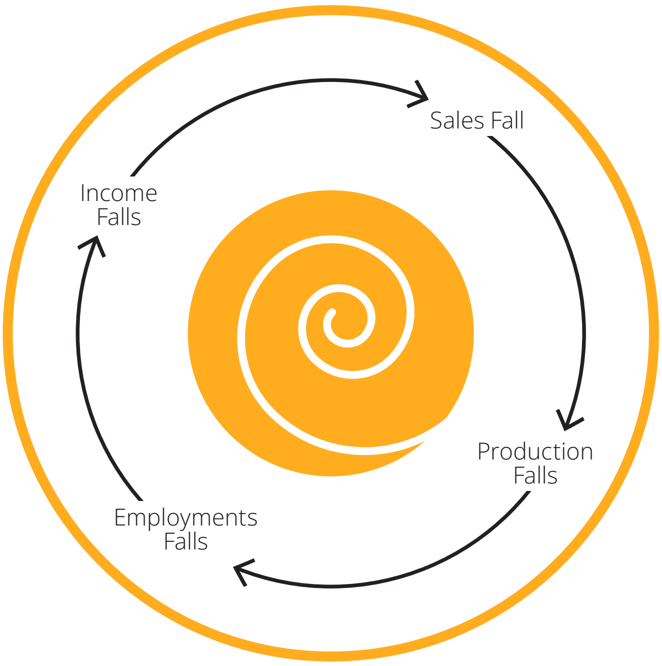
Financial markets people are hard to please. We criticise central banks for being too slow to raise interest rates, when we think inflation is a threat, and equally take them to task for being too slow to cut rates, when growth is threatened. Usually, this is done with the benefit of hindsight!

There's no shortage of market participants who argue that the Fed has, once again, been too slow to cut rates and consequently set the US economy up for a significant slowdown, potentially even a recession.

US jobs growth over June to August was much weaker than expected[1] and so maybe the first recession shoe has already dropped, irrespective of the Fed's near-term policy actions from here.

A loss of employment momentum is part of a vicious cycle (Chart 1) that can lead to a slowdown, at least, or recessions, at worst. Bear in mind too, the often significant lead-times associated with the knock-on effects of monetary policy, which is a blunt instrument.

Chart 1: Maybe a vicious cycle is already underway



A Vicious Cycle

Source: *The business cycle basics of this recession*, Lakshman Achuthan, Economic Cycle Research Institute (ECRI), May 10, 2020, https://www.investopedia.com/the-business-cycle-basics-of-this-recession-4844454

1 *Weak jobs data shifts Fed rate-cut debate from when to how many*, Bloomberg Economics, August 2, 2024, https://www.bloomberg.com/news/live-blog/2024-08-02/us-employment-report-for-july

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Pessimists also cite the "Sahm Rule"[2] which identifies the start of a recession "when the three-month moving average of the national unemployment rate rises by 0.50 percentage points or more relative to its low during the previous 12 months."[3]

US employment data would suggest that Sahm Rule conditions have now been met. Even so, it would be simplistic to latch on to any single 'rule,' model, or piece of data to reach such a weighty conclusion.

To be clear, the pace of US employment growth is falling, however, companies are not slashing labour. A decreasing pace of employment growth reinforces the picture of a slowing economy, but that could simply be because America is closer to full employment and labour force participation has picked up.

What about Australia?

Despite Australia's inflation rate now having fallen to within the Reserve Bank of Australia's (RBA) 2-3% target inflation rate, there would appear to be little chance of changes to policy rates any time soon to give business and households relief.

The RBA remains boxed in by sticky services inflation, and persistent food, rents, insurance, and education price pressures.[4]

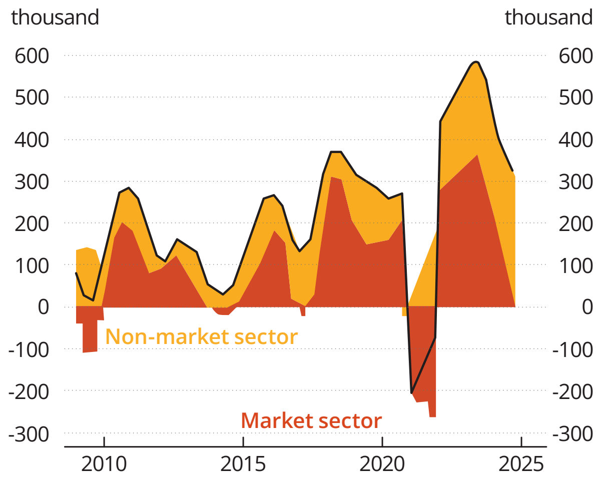
Meanwhile, Australia is in a Gross Domestic Product (GDP) recession having recorded six consecutive quarters of negative per capita growth while total GDP rose just 1.5% over 2023–24.[5]

Labour market stresses have also emerged with private sector employment stalling, even as the care economy (allied health, aged care, and child care) and public sector employment continues to grow (Chart 2), arguably masking what would otherwise be more obvious signs of employment market cracks.

In other words, the vicious cycle, or perhaps the commencement of one, portrayed by chart 1, may be underway in Australia too.

Chart 2: Private sector employment has been stalling

Comparison of Non-market sector* and Market sector employment: employed persons (annual change, number, trend)



* The non-market labour market is defined by the Australian Bureau of Statistics (ABS) as comprising health care and social assistance, education and training and public administration and safety. These industries are tied to government services and are less responsive to cyclical changes in the economy.

Source: Australian Bureau of Statistics, Commonwealth Bank of Australia, Macrobond

2 *Sahm Rule Recession Indicator*, Federal Reserve Bank of St Louis, https://fred.stlouisfed.org/release?rid=456#:~:text=The%20Sahm%20Rule%20identifies%20signals,during%20the%20previous%2012%20months.

3 Ibid

4 *Monthly Consumer Price Index Indicator*, Australian Bureau of Statistics, 25 September 2024, https://www.abs.gov.au/statistics/economy/price-indexes-and-inflation/monthly-consumer-price-index-indicator/aug-2024

5 *Australian National Accounts: National Income, Expenditure and Product*, Australian Bureau of Statistics, September 4, 2024, https://www.abs.gov.au/statistics/economy/national-accounts/australian-national-accounts-national-income-expenditure-and-product/latest-release

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Reporting season takeaways, P/E expansion

The recent listed company reporting season also gave investment professionals plenty to mull over.

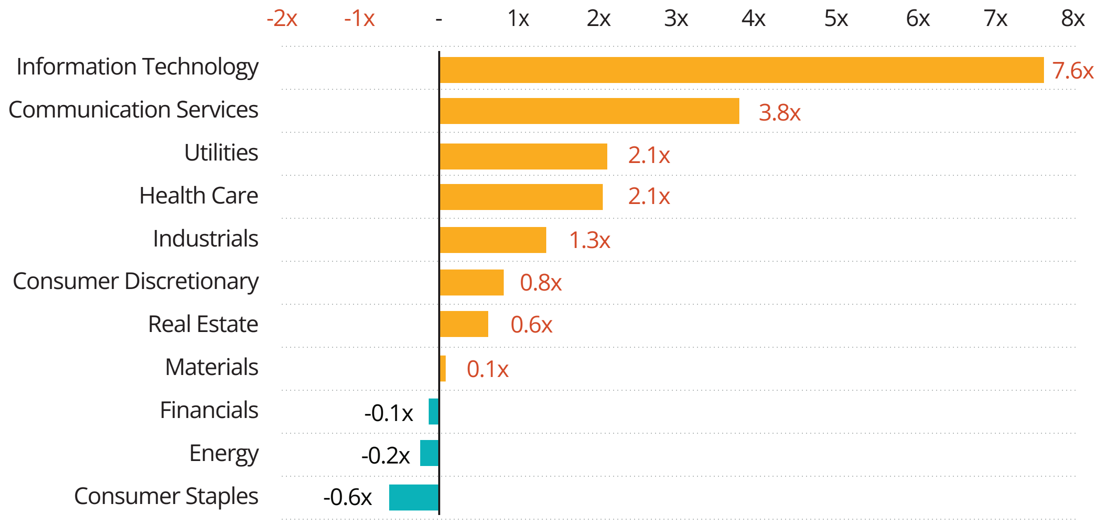
Here are a few takeaways:

- Generally, corporate Australia delivered on its financial year 2024 earnings forecasts. However, financial year 2025 guidance was for lower earnings growth on the back of increasing margin pressures.
- Sales or volume growth is difficult.
- Businesses are dealing with an unpalatable cocktail of elevated labour costs, high rents, and energy and transport costs, as well as steeper debt servicing costs.
- Feedback from companies confirm that cost-of-living pressures are causing changes in consumer behaviour and spending patterns.

Here’s the twist; despite all the above, as well as falling consensus earnings expectations, share prices were largely stable, and in some cases even increased, with the upshot that price-earnings (P/E) multiples increased (Chart 3), an unusual outcome.

Chart 3: Falling earnings expectations coupled with stable share prices = P/E expansion

S&P/ASX 100 P/E expansion by sector over August 2024



Source: J.P. Morgan, Bloomberg Finance LP

Only the Financials, and Energy sectors saw a higher proportion of companies experience P/E compression (Chart 4, on next page) versus those exhibiting P/E expansion.

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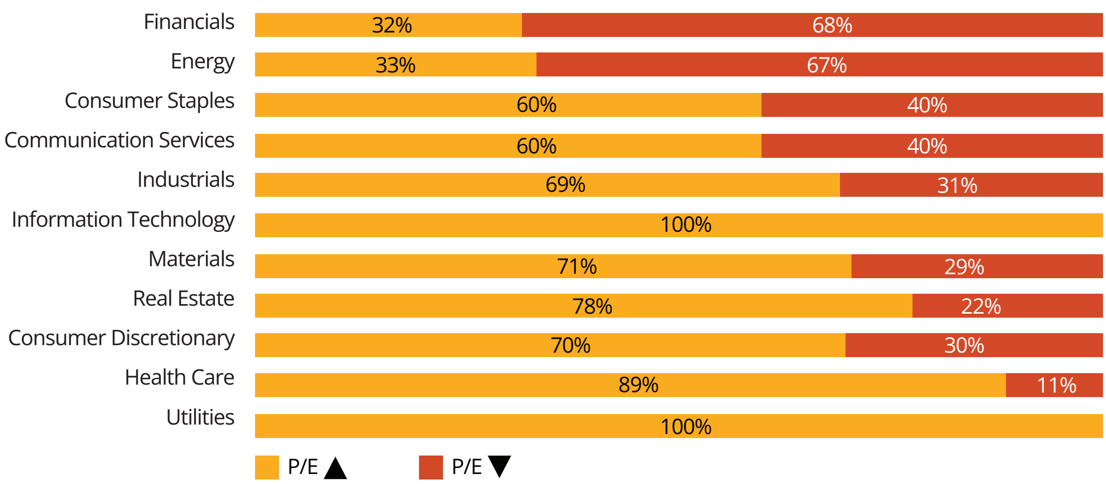
Chart 4: Except for Financials, and Energy sectors, all other sectors exhibited P/E expansion

S&P/ASX 100 sectors: P/E expansion vs compression



Source: J.P. Morgan, Bloomberg Finance LP

The P/E data portrays a puzzling level of optimism causing J. P. Morgan, in a report, to describe the situation as "world-leading P/E expansion."[6]

Valuations matter, so does active management and diversification

Across all investment markets, and over time, we strongly believe valuations matter. Like gravity, underlying earnings, cashflows, and distributions are needed to support valuations.

Applying this logic, what we term elevated 'starting valuations' present an inherent risk to investor capital, typically indeterminate in nature.

Just about everything in this note, to this stage, should lead us to a cautious outlook for equities and economies. However, that assumes only one outcome is possible.

Our active investment approach considers and models multiple potential future outcomes with a wide distribution of asset class return possibilities. Doing this means we are always alive to the possibility of a slew of positive and negative 'tails,' amongst other things, something unlikely to be captured by investment approaches built around a base case, along with a bull and bear scenarios.

Diversification is another of our investment principles. It's why we are such strong advocates for multi-asset, multi-manager investing. By investing in this way, portfolios are not dependant on a single asset class, theme, investment style, or manager for success.

Instead, returns are sourced from many asset classes, many assets within asset classes, and many investment styles and philosophies.

It certainly means that our multi-asset portfolios are not hostage to equity markets, exclusively, for strong long-term returns.

6 *The results dissector: A faltering finish*, J. P. Morgan, 30 August 2024

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Can swing capital to private credit, including "esoteric private credit"

If, for instance, we believe sharemarket returns may be more subdued in the period ahead, with potentially greater downside risks on the back of a sharper economic slowdown, we can deploy more client capital to private credit. We regard this asset class as attractive given the yield advantage versus traditional bonds, supported by the asset classes' standing as senior debt in the capital structure, relatively short maturities, and lenders' covenants.

Moreover, as we see it, lending standards by managers, we have relationships with, have not been loosened, and default rates have remained reassuringly low.

We also think the hard-to-access world of "esoteric private credit" can provide very attractive yields along with diversification benefits.

In this space, we partner with specialist managers who invest in privately negotiated deals where we lend to counterparties who often need capital quickly (and so are willing to pay up), but are also able to provide very attractive assets or cashflows to back the loan (making the risk-return compelling).

While still offering some appeal, traditional corporate credit is not as strong a diversifier, compared to equities, in our view, as they are still subject to similar risks eg. economic cycles, interest rates, or both.

Within our alternatives capability and real return strategies, our focus is on more esoteric credit investments backed by high quality assets and cash flows uncorrelated to the broader economy.

Some of the strategies we invest in include:

- **Capital solutions**; examples include loans to borrowers secured against investment grade corporate receivables
- **Special situations**, such as bridge loans to real estate developers post planning approvals
- **Legal finance**; financing attorney fees due from an agreed legal settlement, and
- **Minority shareholder protection**; pursuing legal action for fair value following "squeeze out" of minority shareholders in a merger transaction

It's been our willingness to research and then selectively commit clients' capital to niche and complex areas of capital markets that have been pivotal to our success. Our relationships with outstanding specialist managers and bespoke arrangements have also been key drivers behind our strong investment outcomes in this space.

It's a cliché but nevertheless warrants repeating. Investing is a distance-event, not a sprit. Patience, asset allocation and manager selection skill, and sound judgements, borne from navigating many market cycles are foundations for success.

This is consistent with our emphasis on building *robust* (for a range of potential future outcomes), as opposed to *optimal* (for a single or narrow range of outcomes) investment solutions. By doing this, we believe we can deliver consistent, long-term returns for our clients.

Important information

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