Perpetual Private | Quarterly Market Update

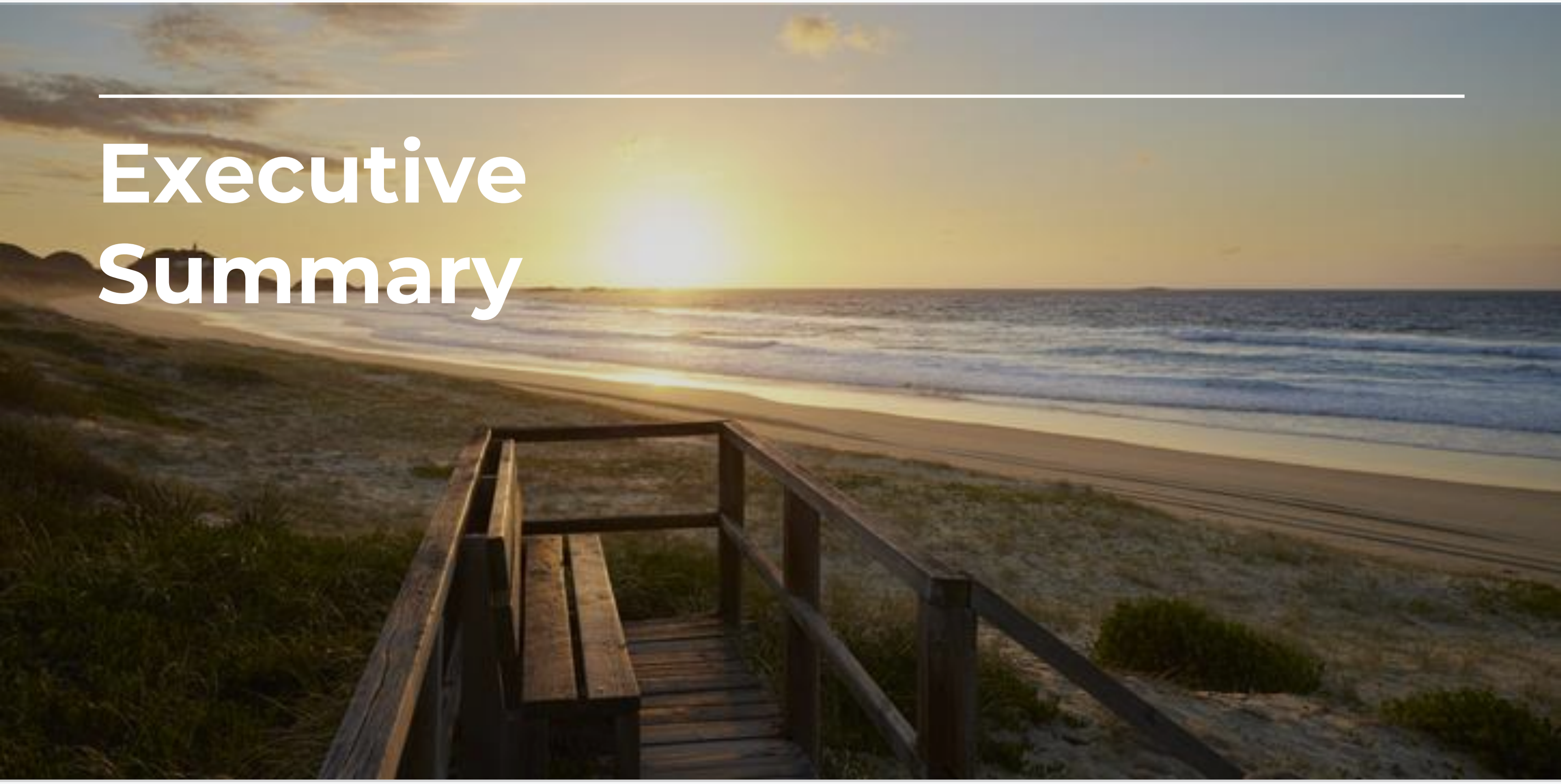
"Let them eat cake"

June 2024

Trust is earned.

Perpetual

Contents



Executive Summary

The 2024 financial year concluded with markets in rude health. Despite continued conflicts and heightened geopolitical tension, a cost of living 'crisis', sharp increases in interest rates, and a series of contentious elections in France, the U.K. and the U.S.; shares climbed the proverbial 'wall of worry', with a number of markets hitting and exceeding previously held all-time highs.

It is interesting to consider that in the face of higher mortgage payments and sharp gains in the prices of staple goods, consumers have displayed remarkable resilience. As we know, many had expected a recession by this point in the cycle. However, a combination of persistent spending behaviour, robust labour markets and A.I. inspired optimism, has kept the 'wolf from the door' of the global economy.

Central banks globally, including our own RBA, are at pains to emphasise that they are walking 'a narrow path', hoping to tame inflation without driving economies into recession. That task is usually difficult, with the record showing our monetary authorities fail more often than not. We have explained in these pages in the past, the complicated nature of monetary policy, with its long and variable lags. Add to this the complication of uncoordinated government spending, and it is fair to feel somewhat sympathetic for the challenges faced by central banks.

In this report we contemplate the drivers of what has been a good year for investment returns, before diving below the surface and discussing some of the imbalances and dislocations which could impact outcomes as we move forward.

Indeed, the title of this report, "Let Them Eat Cake", is an acknowledgement that within economies there are clear 'haves' and 'have-nots'. Young Australians for instance, are having a significantly more difficult time, than retirees. Similarly, big companies are enjoying far more conducive conditions than their smaller counterparts.

As we proceed into 2025 and beyond, there are numerous elements that could become tailwinds if they play out in one way, or headwinds if they play out the other. These include the Chinese economy, conflicts in Ukraine/Russia and Israel/Gaza, the timing of productivity gains from artificial intelligence, and bringing inflation back within manageable levels.

In the following pages, we delve into the key areas that will likely drive markets in the coming months, including a special feature on the U.S. presidential election. Our usual Asset Class Snapshot has been made more succinct, with deeper dives into each after the Global Economic Overview.

Asset class snapshot

Inflation and central bank policy expectations continued to be key drivers of investment market performance throughout Q2 2024. Early in the quarter, hotter-than-expected inflation data and higher bond yields weighed on asset prices leading investors, particularly in the U.S. and Australia, to adjust their expectations for when each country's respective central bank would loosen (or even potentially tighten) monetary policy. This shift resulted in the first bout of 2024 volatility. However, continued economic growth, albeit at a muted pace, and ongoing enthusiasm around artificial intelligence (A.I.) helped buoy investor sentiment and push asset prices higher later in the quarter.

An increasingly clear trend this quarter, continuing on from a familiar theme seen over the last twelve months, is that a narrow group of companies have performed exceptionally well, keeping most major indices in the green for FY24. However, this has masked the fact that many index constituents have materially lagged the market.

Australian equities

The second quarter of 2024 saw a minor consolidation of recent share market gains, with the S&P ASX 300 ending the quarter down 1.2%. Larger companies showed relative resilience with a modest decline of 0.8%[1], whereas smaller companies faced more significant challenges, dropping 4.5%[2]. In April, rising bond yields initially put pressure on smaller names, and as the quarter progressed, concerns over economic growth further impacted these companies. From an investment style perspective, **Growth** (+0.4%[3]) stocks outpaced **Value** (-1.9%[4]) stocks during this period.

Sector performance within the ASX 300 was mixed, with five out of eleven sectors posting positive returns. Utilities led the gains with an impressive 13.3% return, followed by **Financials** (+4.0%), **Information Technology** (+2.4%), and **Health Care** (+1.9%). On the other hand, the **Energy** sector fell by 6.7%, **Materials** (-5.9%), and **Industrials** (-4.3%), reflecting mounting concerns about future economic growth, ongoing issues in China, and the potential effects 'higher for longer' monetary policy will have on the Australian economy.

International equities

Q2 2024 presented a mixed picture for international equities. While the global index, the MSCI All Country World Index (ACWI), delivered a modest return of just 0.5% in Australian dollar (AUD) terms, local currency (USD) returns painted a brighter picture at 3.4%. This divergence highlights the significant impact a surging AUD had on international investment returns during the quarter.

The ongoing strength of the A.I.-fuelled technology rally was a key driver of market performance. The MSCI ACWI experienced a narrow sectoral performance, with only three sectors finishing in positive territory. **Technology** (+8.8%) reigned supreme, driven higher by stellar earnings from **A.I.** giants like **Nvidia** (up 36% in Q2) - which briefly held the title of the world's largest company - **Microsoft**, and **Amazon**. **Communication Services** (+5.6%) also enjoyed strong gains. However, the dominance of the tech sector masked a more nuanced story for other parts of the market. Sectors not directly tied to the A.I. theme, such as **Energy** (-3.1%), **Materials** (-5.4%), and **Industrials** (-4.1%), lagged. This reflects growing investor anxiety about the pace of future economic growth and its impact on cyclical sectors. It would come as no surprise that from an investment style perspective, **Growth** stocks continued their dominance, clocking a return of 3.5%[5] compared to **Value's** -3.9%[6].

The trend of **Large Caps** outperforming **Small Caps** continued in Q2. The MSCI AC World Small Cap Index suffered a decline of 3.8%, a stark contrast to its early 2024 momentum. Further evidence of market divergence emerged when examining regional performance with **Emerging markets** (+2.6%[7]) outperforming **Developed markets** ex-North America (-2.7%[8]) thanks to China's resurgence and strong A.I.-linked markets in Asia. And unlike the broad rally seen in Q1, Q2 witnessed lagging performance in the UK, Japan, and the Eurozone, highlighting that each region is grappling with its own unique blend of challenges - taming inflation while maintaining growth - at different speeds and with varying degrees of success.

[1] As measured by S&P ASX 100 index
[2] As measured by S&P ASX Small Ordinaries index
[3] As measured by MSCI Australian Growth index
[4] As measured by MSCI Australian Value index
[5] As measured by MSCI World Index Growth index
[6] As measured by MSCI World Index Value index
[7] As measured by MSCI EM (Emerging Markets) index
[8] As measured by MSCI EAFE index

Real estate

Real Estate Investment Trusts (REITs), sensitive to interest rates due to higher borrowing costs and reduced present value of future cash flows, struggled as bond yields rose early in the quarter. After strong performance in Q1 2024, Australian (A-REITs) declined by 5.6%[9] in Q2, though they still posted a robust 23.8% return for FY24, driven largely by **Goodman Group's** gains from increased demand for data centres. Global (G-REITs), affected by higher global bond yields and a stronger Australian dollar, fell 4.7%[10] in Q2, with a modest 4.2% return for FY24. Commercial office valuations continued to weigh on the index due to low occupancy rates from post-COVID **remote work trends**, while more defensive sectors like residential, self-storage, and healthcare performed better. All major regions finished the quarter in the red in AUD terms, with Hong Kong - affected by China's ongoing property market issues - and Japan, lagging the most.

Alternatives

Our approach to Alternatives is to harness differentiated returns, with a focus on assets that exhibit low levels of correlation with traditional asset classes.

For institutions with the access and expertise to invest in this broad array of different asset classes and strategies, increased diversification and the potential to generate more reliable overall portfolio returns represent significant benefits for investors.

In FY24, we saw mixed performance across different alternative asset classes, reflecting the evolving economic landscape. Demand for **infrastructure** assets softened, with deals staying in the market despite repricing. This underscores the importance of managers focusing on high-quality assets with strong cash flows. The unlisted real estate market experienced continued turbulence, particularly around the "future of office" theme. Income alternatives saw strong flows into **private credit**, though demand outpaced supply. There was a slight increase in defaults, especially in smaller deals, leading to stricter underwriting standards. Non-investment grade spreads remained stable overall, but individual name dispersion increased due to refinancing activity. Overall, careful manager selection within alternative asset classes remains crucial.

[9] As measured by S&P ASX 300 A-REIT index
[10] As measured by FTSE EPRA Nareit Developed index

Fixed income

Over the past three months, yield curves in both the U.S. and Australia saw significant upward shifts in April before stabilising and partially settling through June. Some developed market central banks have now started their rate cutting cycle to support growth as inflation pressures fade, but the pace of policy easing will be more modest compared to expectations a few months ago. **Australia, likely to be one of the last Developed countries to cut,** with inflation remaining above the RBA's target, creating a domestic bias towards further tightening.

Examining these changes through the lens of global bond benchmark, the Bloomberg Global Aggregate, saw a slight negative return of 0.2% for the quarter, buoyed by a strong June performance (+0.8%). Domestically, the scenario was similar, with the Bloomberg AusBond Composite (0+Y) returning -0.5% in the June quarter.

Credit markets, benefiting from lower duration and higher nominal yields, fared somewhat better. In Australia, this resulted in a positive return of 0.2%[11] for credit, though widening **credit spreads** dampened the overall return. The AusBond Bank Bill Index, with minimal duration and credit exposure, delivered 1.1% return for the period.

Australian Cash rate

The Reserve Bank of Australia (RBA) maintained the cash rate at 4.35% throughout the quarter but adopted a more **'hawkish'** tone in response to persistent inflation. In May, inflation surpassed expectations, reaching a six-month high of 4.0% year-over-year, while the labour market remained tight. GDP growth fell short of forecasts, expanding only 0.5% on an annualised basis in Q1. The likelihood of an RBA rate hike later this year is increasing as the bank grows impatient with 'sticky' above target inflation.

Australian dollar

The Australian dollar saw **broad appreciation** against most currencies in the June quarter as the RBA considered whether to hike interest rates again amid a global trend of central banks contemplating or implementing rate cuts. This repricing of rate expectations supported the AUD against the US dollar (USD), resulting in a 2.4% rise to AUD 0.67.

U.S. Presidential Election

Late update: *Donald Trump has just survived an assassination attempt, likely boosting his chances of being re-elected and reminding us all just how dangerous political polarisation can be. He remains the Republican Party's presidential nominee, and Joe Biden remains the Democratic candidate*

The U.S. Presidential election applies a layer of uncertainty across the investment landscape. Despite the robust performance of investment markets over the past eight months, the upcoming election could disrupt the 'soft landing', low volatility environment investors have grown accustomed to. Admittedly, we believe that investors sometimes overstate the impact that the federal government has on broad financial markets. Monetary policy is likely to have a greater influence on risk assets in the next few years than any forthcoming legislation or executive action taken by the next president. Nevertheless, it is valuable for investors to evaluate the upcoming election to determine the likely impacts each candidate will have on financial markets and, in turn, investors' portfolios.

At the time of writing, Donald Trump remains the Republican Party's presidential nominee, and Joe Biden the Democratic candidate. However, neither is guaranteed to be on the ballot come November 5th. Trump faces several high-profile court cases, though a recent U.S. Supreme Court ruling makes the possibility of him being disqualified highly unlikely. Biden, on the other hand, is under growing pressure to step aside for a younger candidate, after a lacklustre performance in the first presidential debate. In spite of this, he is steadfast, potentially diminishing the Democrats' re-election chances, as Trump is leading in 11 out of 12 U.S. national surveys taken after their first debate according to Real Clear Politics' poll tracker.

The Two Current Candidates and Their Policies

Let's take a look at both candidates' policies and the expected impact on markets in both presidential scenarios.

Trade and Investment

Biden: Would continue current trade policies, reducing the risk of short-term volatility in investment markets.

Trump: Proposing greater protection for U.S. industries, with a 10% baseline tariff on all imports and a 60% tariff on Chinese imports. This would result in an escalation in the trade war with China and could lead to other nations retaliating with their own form of tariffs against the U.S. This would likely result in structurally higher long-term inflation. A recent study by Moody's stated that the proposed trade restrictions could also cost the U.S. 675K jobs and lower U.S. GDP by 0.6%.

Immigration

Biden: Plans to manage illegal immigration by hiring more border security agents, immigration judges, and asylum officers. A continuation of the status quo is unlikely to reduce immigration materially. This would benefit industries that are reliant on immigrant workers who are often paid less than native-born Americans.

Trump: Proposes a harsher stance on both legal and illegal immigration through 'heavy handed' measures, which could reduce the flow of people into the U.S. However, this approach would likely place upward pressure on wages and could create demographic challenges in the future, given that the U.S. already suffers from an ageing population, not to mention what would happen if he followed through on his threats of deporting some 8-9 million illegal immigrants.

Energy

Biden: Would continue his position on climate-friendly policies, reducing emissions, and accelerating the transition to net zero in line with the Paris Agreement. Renewable energy companies and projects would likely be a major beneficiary of Biden being re-elected for a second term.

Trump: Aims to expand the fossil fuel industry and withdraw the U.S. from the Paris Agreement, reversing America's commitment to reach net zero emissions by 2050 and making it an outlier among the majority of nations.

Defence

Biden: Plans to strengthen alliances and provide additional funding to NATO to counter Russia and China, reinforcing the U.S.'s role as the 'world's policeman' and benefiting defence and aerospace equities.

Trump: Intends to avoid new wars and pressure NATO members to either increase their military spending or face the possibility of the U.S. withdrawing from NATO altogether, which could lead to a stronger U.S. dollar as investors flock to 'safe haven' assets.

Tax

Biden: Likely to increase individual and corporate taxes once the Trump-era tax cuts expire in 2025, reducing corporate earnings and potentially discretionary spending by high-income earners.

Trump: Aims to make the tax cuts permanent, increasing the budget deficit. Currently, U.S. government debt is sitting at ~125% of GDP and with no sign of that improving, the U.S. could see U.S. Treasury bond yields rise as investors become less certain about the growth and inflation outlook.

The Federal Reserve (Fed)

Biden: Supports the independence of the Federal Reserve and is likely to re-elect Fed Chair Jerome Powell in 2026, allowing the Fed to ease monetary policy once they believe they have brought inflation sustainably down to their target.

Trump: Seeks to influence the Fed into becoming more 'dovish' and also reduce its independence, with plans to replace Jerome Powell when his term expires. This could result in monetary policy being loosened too soon, leading to inflation and longer-term inflation expectations moving above the central bank's target.

Overall, a Trump victory could potentially weaken U.S. democracy and lead to increased protectionism and tariffs as the U.S. retreats from globalisation. Individual policies of Trump's would impact certain industries, however, the main market reaction to Trump being elected would likely be higher U.S. Treasury yields due to many of his policies being considered inflationary. In addition, the U.S. dollar could see a rally with investors flocking to the 'safe haven' currency as global economic uncertainty rises. A Biden victory means continuity in the 'status quo', with less unpredictability and uncertainty – an economic environment that has historically led to lower volatility.

Investors should closely monitor each candidate's proposed policies and consider the potential outcomes of a second term for either Trump or Biden, as this will introduce uncertainty and volatility leading up to the 5 November election.

Here are some key considerations for investors who are monitoring the U.S. and other global elections and wondering how they should position their portfolios accordingly.

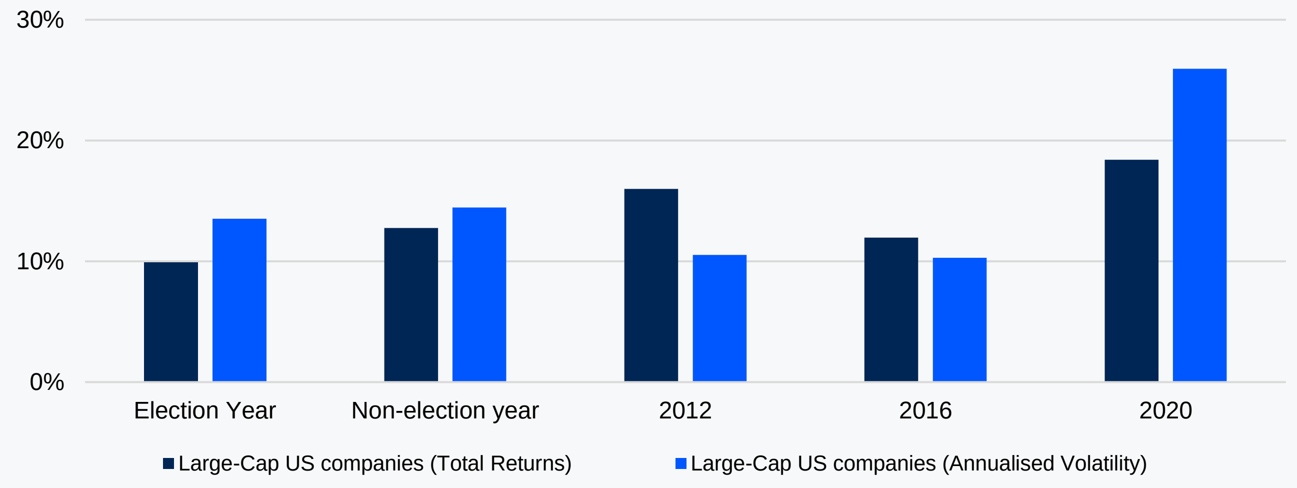
Separate Politics from Investing

Don't let political views influence your investment decisions. Economic sentiments often align with political affiliations. However, broader economic conditions - like lower interest rates - are more impactful on market performance than presidential policies.

Temporary Market Volatility

Election years usually bring lower returns and higher volatility. As shown in figure 1, U.S. Large Cap stocks average 9.9% returns in election years versus 12.8% in non-election years, with volatility at 13.5% and 14.4%, respectively. Market volatility tends to spike before elections but stabilises afterwards, with investors refocusing on fundamentals.

Figure 1: U.S. Large Caps - Total Returns and Annualised Volatility (USD) - (Monthly Returns 1937 - 2023)

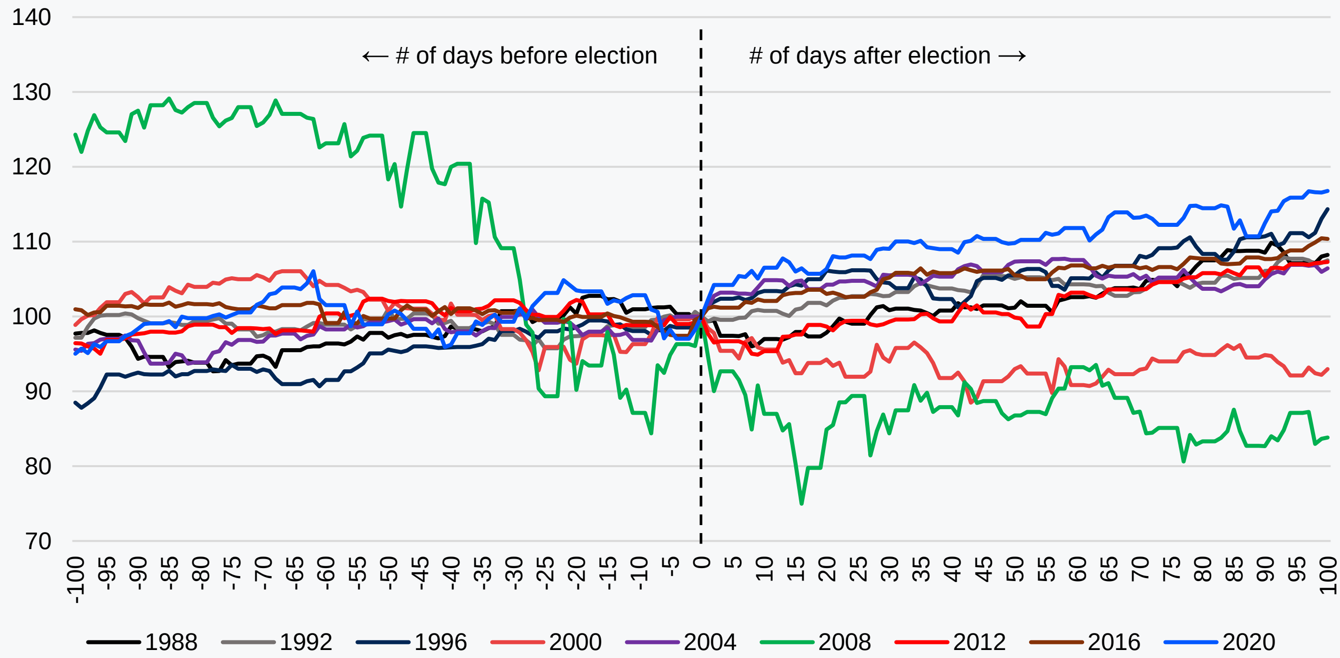


Source: Morningstar - US Large-Cap Stocks (Monthly Returns 1937 - 2023)

Avoid Market Timing

Timing the market around elections is risky. For example, as shown in figure 2, markets rebounded quickly in 2016 and 2020 after initial election night drops. Sitting out due to election uncertainty risks missing these rebounds.

Figure 2: S&P 500 - Total Returns (USD) Pre and Post U.S. Elections - (Election date = 100)



Source: FactSet - S&P 500 Total Returns (USD). Data from 1988 - 2021.

Election Outcomes and Future Performance

Market performance under different government configurations often misses larger economic factors like monetary policy and growth. Economic cycles don't align neatly with presidential terms, making it hard to base strategies on political outcomes. Elections are important, especially the 2024 U.S. election, but the effect elections have on markets tends to be indirect and delayed. Even if investors are able to successfully predict which candidate will be elected and the policies they will enact, the timing and magnitude of impact on investment markets is uncertain. As a result, investors should maintain a disciplined, long-term approach to achieve their financial goals and avoid reactive decisions that could permanently impair capital.

Global economic overview

'I wouldn't be dead for quids'

'I wouldn't be dead for quids', is an old turn of phrase used amongst traders. It is used to express the feeling that times are so good or so interesting, that you wouldn't want to miss them. Reflecting back on the quarter and year that have just passed, we think it is fair to say that what we have experienced in markets has been both *good* and *interesting*.

With economies and capital markets digesting both the end of ultra-low interest rates and the aftermath of the pandemic, we have been traveling through an environment where adjustments to consumer behaviour, business models and valuations, have all been occurring simultaneously. Of course, these 'tiers' of the investment landscape are interrelated. So, each round of adjustments then triggers another, gradually moving towards a new equilibrium point, wherever that might ultimately eventuate.

Despite the challenges of the economic environment, including the burden of inflation on the cost of living, and the greatly increased cost of debt; markets have roared ahead, with many reaching all-time highs during the period.

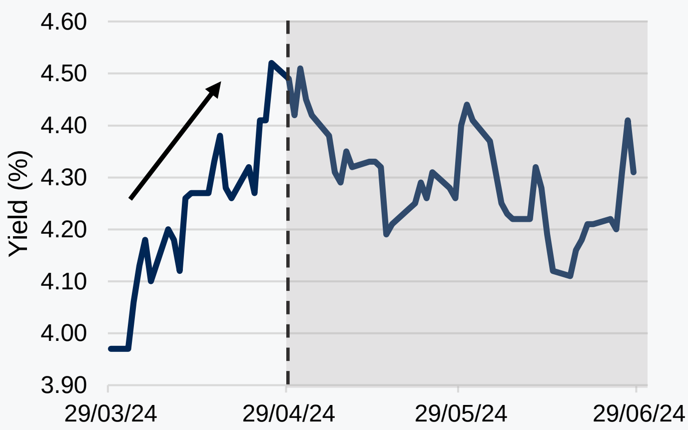
Indeed, if we turn our focus to our domestic share market, as represented by the S&P ASX 300 index, we have enjoyed gains of 11.9% over the past 12 months[12], albeit fading by 1.2% in the last quarter. International markets have been even more impressive, gaining 19.0%[13] over the year and 0.5% over the quarter; driven by the ongoing strength of the U.S. tech sector. As is now almost universally known, the emergence of A.I. has driven 'magnificent' gains in earnings and market sentiment. This has powered global technology stocks upwards by 37.2%[14] over the year, and 8.8% over the quarter. Indeed, the leading light of this new technological advance, Nvidia, increased in value by 192.0% over the year, and 36.7% in the three months to June 30th. The irony that the name Nvidia, was derived from the Spanish word for envy, 'envidia' (and should be pronounced as such) should be lost on no one. All of this in a period that just 18 months ago, had been expected to include a global recession by some 80% of economists.

Of interest, is that this has not occurred against a backdrop of calm waters. Numerous conflicts continue to simmer globally, the political environment in Western democracies has been increasingly factious, families continue to struggle with cost-of-living pressures, and higher interest rates have increased the cost of debt for businesses and consumers alike. Despite this, the consensus belief in an economic 'soft landing', remains intact and possible. General economic activity remains relatively robust and labour markets, generally strong. The primary conundrum that economies face, in inflation and interest rates, is the same as what they have battled since early 2022, when it became clear to central banks that inflation was not going to be 'transitory', as had initially been expected.

12 To the close of business, 30th June 2024
13 As measured by the MSCI All Country World index
14 As measured by the MSCI AC World Information Technology index

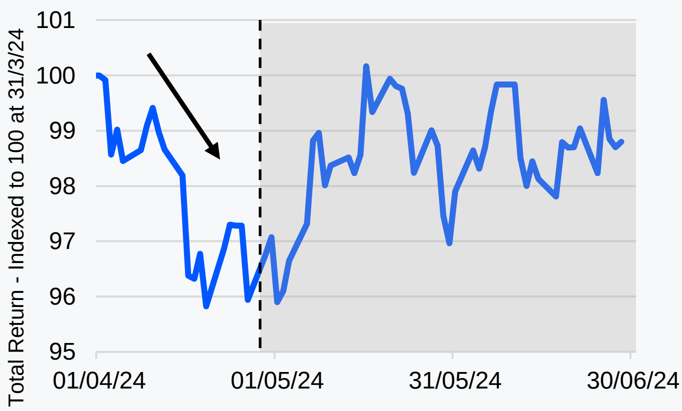
We have commented here previously that inflation and interest rates were becoming less important for the outcomes of investments. In this quarter we have some clear examples of this 'in the wild'. As we show in figure 3 and 4 below, in Australian equity markets[15] an increase in interest rate expectations has largely driven equity returns down over the quarter, with some respite in June as rate expectations settled back. In the U.S. the same pattern can be observed, with yield curves reflecting heightened interest rate expectations over the quarter but a reduction over the month of June (figure 5). Here, a gain in earnings counteracted some of the impact of rates, resulting in positive returns over the quarter and the month. Shares were not entirely immune however, with advances in price being predominantly generated in June, enjoying the tailwind of the hopes of monetary easing.

Figure 3: Australian 10yr Government Bond Yield - June Quarter (%)



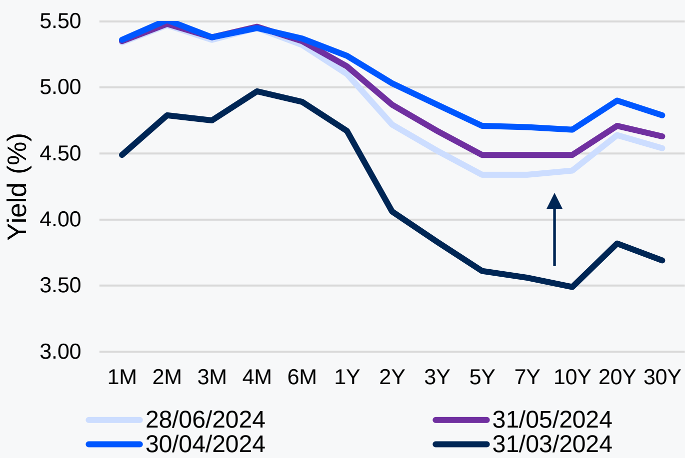
Source: FactSet, Perpetual Private. Data as of 30 June 2024

Figure 4: S&P/ASX 300 - Total Return (Indexed to 100 - June Quarter)



Source: FactSet, Perpetual Private. Returns are gross of fees and in AUD. Data as of 30 June 2024

Figure 5: U.S. 10Y Treasury Yield Curve - June Quarter (%)



Source: FactSet, Perpetual Private. Data as of 30 June 2024

With the market now beginning to approach our long-held belief that target cash rates would indeed be 'higher for longer', we expect the trend towards stock specific risk to hold, with a more cautious approach to easing than many had hoped for. As such, we feel it important to focus our attention on the conditions that exist within markets. Beneath the surface of those buoyant returns over the 12 months are dispersed sector returns. Locally, Financials[16] led the pack, generating a total return of 29.0%, in stark contrast to Consumer Staples[17] which declined by 3.7%. Internationally (unsurprisingly), Information Technology[18] was the leading performer, with gains of 38.8%. Consistent with our domestic experience, Consumer Staples[19] was the laggard, limping in with only 2.3% over the year. This theme of widely different outcomes is something that is occurring throughout the global financial landscape, both across and within asset classes. Clearly, something worth delving deeper into for anyone with an interest in financial markets.

"Qu'ils mangent de la brioche"

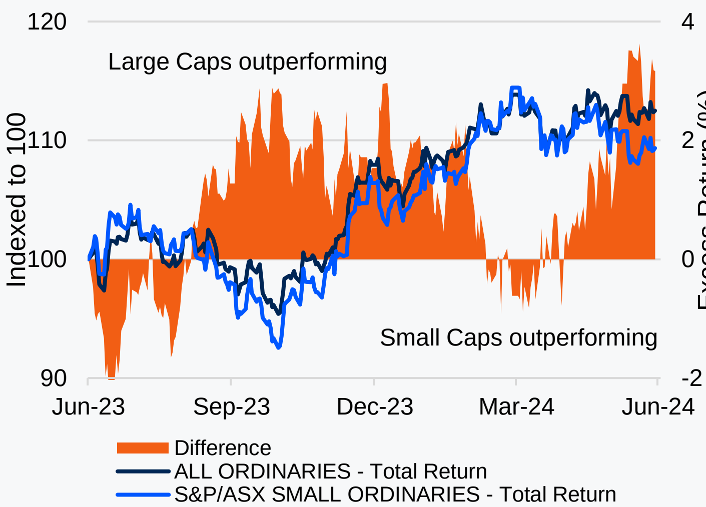
We chose "let them eat cake" as the title of this report as we felt it nicely reflected our observation of 'haves and have-nots' in the current economic and investment landscape. Whilst the expression has popularly been attributed to Marie Antoinette (the last queen of France), basic investigation shows that not only is the saying incorrect (the translation is closer to 'let them eat brioche') but there also appears to be no actual historical record of Marie Antoinette ever saying it. Furthermore, the emergence of the expression in French, is not recorded until 50 years after her death. What is particularly interesting about the phrase is that variations of it have appeared throughout the world at varying times, during periods where 'elites' have increasingly been seen as being out of touch with the rest of society (sound familiar?). Indeed, it's reasonable to argue that the rise of populism over the past decade, is linked to the remedy for the Global Financial Crisis, 'quantitative easing' (QE). An unintended consequence of QE was that it significantly inflated the price of assets.

[15] As measured by the S&P ASX 300 index
[16] As measured by the S&P ASX Financial Ex-REIT index
[17] As measured by the S&P ASX Consumer Staples index
[18] As measured by the MSCI ACWI Information Technology
[19] As measured by the MSCI ACWI Consumer Staples index

As such, those with the most assets, benefited the most; those without, not so much. What has made Donald Trump so popular with his supporters is his ability to so effectively tap into the discontentment that this has generated. Similar dissatisfaction can also be attributed to the British Conservative government being out of power for the first time in 14 years, and a French election that nearly resulted in the first far right government since the Second World War.

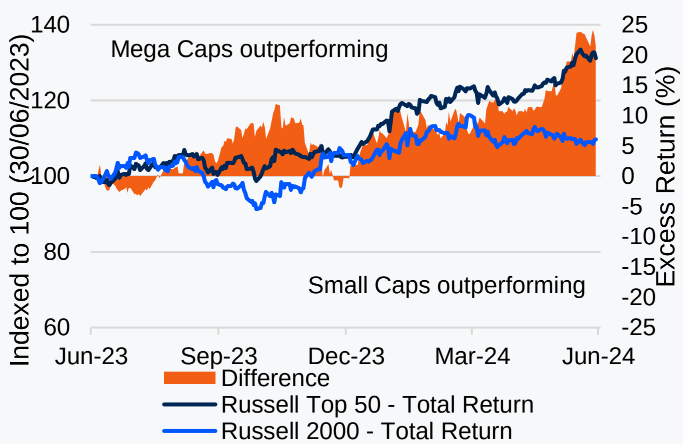
Within the current environment, our analysis has identified numerous examples whereby there has been a disproportionate outperformance enjoyed by one segment versus another. One example of this, is when we consider larger companies against smaller companies (large caps vs small caps). As shown in figure 6 and 7, over the past financial year, big companies have significantly outperformed their smaller counterparts. Whilst that is interesting in its own right, it becomes even more meaningful when we reflect on the fact that over longer timeframes, small caps tend to outperform their larger counterparts (albeit the record in Australia isn't entirely as clear due to structural elements in our market).

Figure 6: ASX Large Caps vs Small Caps (AUD)



Source: FactSet, Perpetual Private. Returns are gross of fees and in AUD. Data as of 30 June 2024

Figure 7: U.S. Mega Cap vs Small Cap (AUD)



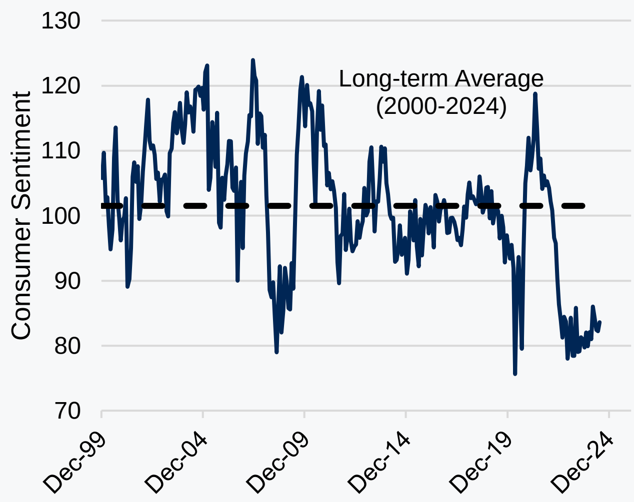
Source: FactSet, Perpetual Private. Returns are gross of fees and in AUD. Data as of 30 June 2024.

Similarly, if we consider the experience of rich versus poor the environment is far more pleasant for the wealthy than for those without significant earnings or assets. Banking statistics suggest that whilst the highest 20% of earners have retained the excess savings they generated during the pandemic, the lowest 20% spent through theirs many months ago. Additionally, a high degree of inflation in essential items, such as food and energy, finds that average Australian families are struggling to make ends meet - their spending falling not only in real terms (adjusted for inflation), but also in nominal terms.

Tied to similar factors is the experience of old and young. Along very similar lines, older, asset-rich people are enjoying booming asset prices and positive real yields on their money. Meanwhile younger people are struggling to meet rising rents, and cost of living expenses, whilst watching house prices move to levels many see as unattainable.

All of which might explain the unusual divergence between consumer sentiment and stock markets. As we show below, the low level of consumer sentiment, is normally associated with market crashes. Indeed, it has only been this low two other times in 30 years. Once in the immediate aftermath of the Global Financial Crisis, and once in the early days of the pandemic when markets dramatically sold off. Now, however, we have an equity market that is hitting all-time highs, whilst consumer sentiment has been at low levels for well over a year now.

Figure 8. Westpac Consumer Confidence Index – Australia



Source: FactSet - Westpac Economics, Melbourne Institute. Data as of 30 June 2024.

Headwinds and tailwinds

In her media conference following the Reserve Bank's June Monetary Policy meeting, Governor Michelle Bullock noted "we're in a really complex part of the cycle at the moment", a sentiment we share.

In the early stages of addressing inflation, the decision is relatively simple; increase rates until inflation recedes back towards target and monitor data for signs of stress. However, we are now at the 'business end' of that process whereby the delicate balancing act of maintaining employment and economic activity, whilst not reinvigorating inflation, must be navigated. All whilst dealing with lagged data and dynamic conditions.

From our perspective, we see a moment in time where there are a number of things that, depending on how they play out, will either be strongly positive for markets, or strongly negative.

Take, for instance, equity market valuations (Figure 9 & 10). If we consider price-to-earnings multiples as a proxy, we can see that valuations both in Australia and the U.S. have been above their long-term average for quite some time now.

Figure 9: S&P ASX 300 – Valuation - Price-to-earnings NTM

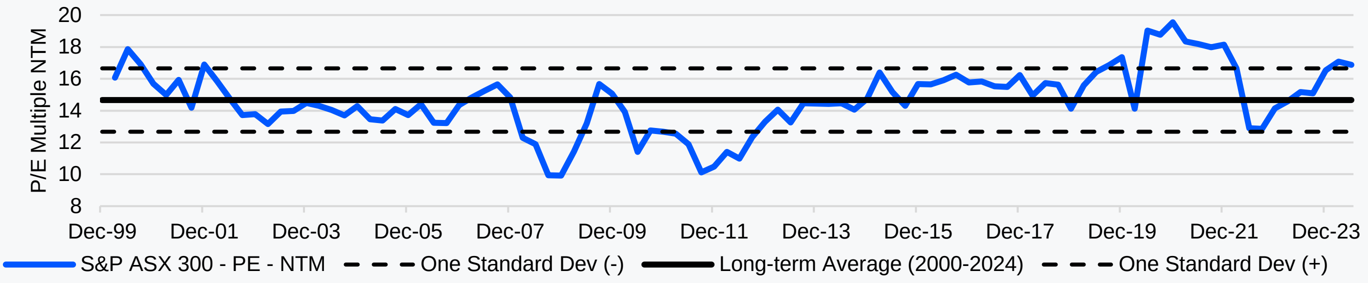
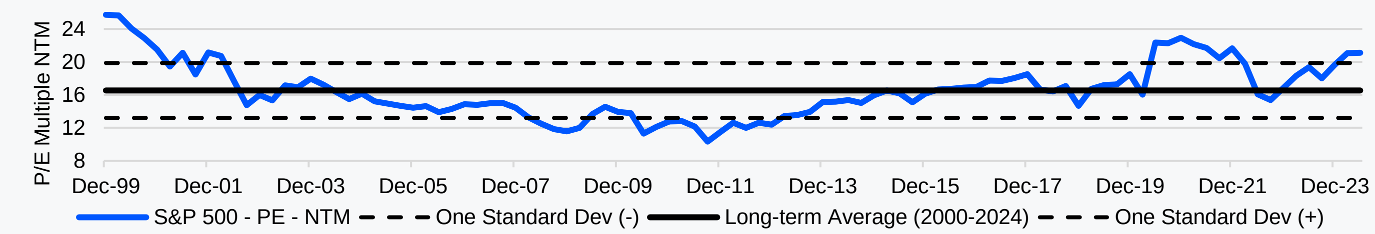


Figure 10: S&P 500 – Valuation - Price-to-earnings NTM

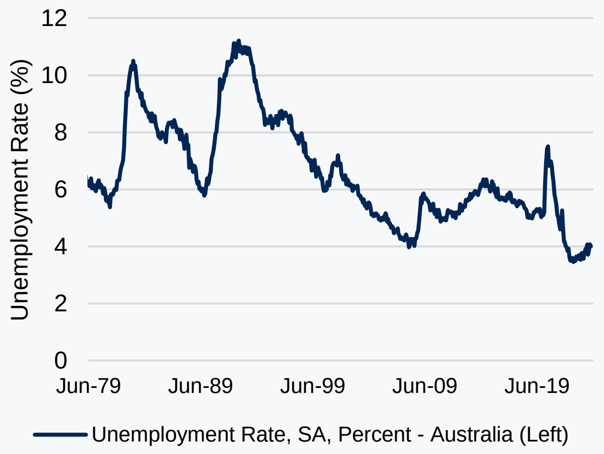


Source: FactSet, Perpetual Private. Data as of 30 June 2024

As you can see, valuations have rarely been this high, outside of the pandemic where monetary and fiscal stimulus were deployed at scale. Since then, interest rates have been increased by over 4% in most regions, something that in past environments has led to lower valuations. Clearly, that is not the case in this instance. What we are likely witnessing is a degree of hope for an economic soft landing, but more importantly an expectation of substantial productivity gains being generated from A.I. (artificial intelligence). Of course, if A.I. delivers such benefits in the near-term, these valuations may quickly appear cheap, with an acceleration in earnings, quickly rationalising a premium over the long-term average.

Something which may be closely related to the implementation of A.I. is the labour market. Whilst it remains to be seen, how much, how quickly and in what way it replaces labour, which is clearly a likely outcome. Indeed, against a backdrop of tight labour markets and historically low levels of unemployment (Figure 11), we see an impressive degree of resilience being demonstrated by the economy. Should that hold through to when the RBA is confident enough to reduce interest rates, this should translate to a buoyant economic environment. If we remember back to the pandemic, much effort was made by governments globally to maintain the connections between employees and businesses (locally via our JobKeeper programme), for this exact reason.

Figure 9. Australia – Unemployment Rate, SA, Percent



Source: ABS. Data as of 30 June 2024

Of course, one thing that has a large influence on our own economy but is also important for global growth, is that of China. As we know, China has been facing strong economic headwinds as their property market struggles with a dramatic slowdown that has not only had direct economic impacts, but has also served to depress consumer behaviour, adding a secondary effect. That the Chinese government haven't been more forceful in their response is curious. The conspiracy theorists among us wonder if this might change following the U.S. presidential elections, with President Xi likely preferring to deal with a unilateral Trump rather than a multilateral Biden; a strong economy typically favouring the incumbent. Of course, the official and equally plausible argument, is that the Chinese Communist Party has learned from the past and is trying to avoid inflating new bubbles by throwing money at the problem. Whilst it remains to be seen whether they are able turn things around, an improvement here will help support the global economy, whilst a setback will weigh on global economic growth, and so the performance of investments.

It would be remis of us not to mention the rising number and risk of armed conflicts in the world right now. At the time of writing, the Israel/Gaza conflict is threatening to expand, with an increasing frequency of skirmishes between the Israeli Defence Forces and Hezbollah in Lebanon. Additionally, Russia has stepped up its attacks against Ukraine likely to seek the upper hand before a probable Trump presidency seeks to negotiate a truce, likely allowing Russia to formally lock in the territories it holds as one of the conditions. Worryingly, there are now some 56[20] active conflicts in the world, the highest since the second world war. Over the past five years, some 100 countries have been involved in some form of external conflict, up from 56[21] in 2008.

Of course, these developments are concerning, particularly when you consider growing Chinese and North Korean assertiveness. However, we share very similar views on conflict as what the Future Fund have recently published in a whitepaper; effectively believing that outside of major regional conflicts, wars and geopolitical fragmentation lead to strategic, rather than tactical, implications (i.e. by placing a higher floor under inflation). Of course, should we encounter a conflict that metastasises, dragging in an escalating number of participants, that would be bad for economies and investments, not to mention the sad loss of life. This is unlikely, as these occurrences are hugely destructive and intrinsically prohibitive. On the positive side, if Israel/Hamas and Russia/Ukraine settle and recede, it will be one less thing for markets to worry about, and whilst not a real burden on returns at present, it would certainly be positive for sentiment.

Evolution not revolution

As investors, we find it to be a good discipline to adhere to the Socratic paradox. To paraphrase, "we know that we know nothing". Maintaining such a degree of intellectual humility is key in making rational decisions in ever changing markets.

Over the coming months, the U.S. presidential election is certain to heat up. Additionally, developments relating to inflation and interest rates will swing markets as participants try to position for likely economic outcomes. As such, we expect heightened volatility over the coming months, as sentiment swings from glass-half-full, to glass-half-empty, and back again.

There are clearly things to be concerned about, but there are also many things to be hopeful for, with probabilities balanced and outcomes wide. Many of the observations we describe throughout this report, have the potential to become significant sources of optimism, but also present the risk of disrupting markets. Either way these play out, they will be certain to provide opportunities for keen-eyed investors.

As always, it remains our key priority to continue to analyse economic conditions and investments, seeking to be positioned defensively in tough times, whilst also being ready to take advantage of dislocations between price and value.

[20] Institute for Economics and Peace – Global Peace Index 2024

[21] Institute for Economics and Peace – Global Peace Index 2024

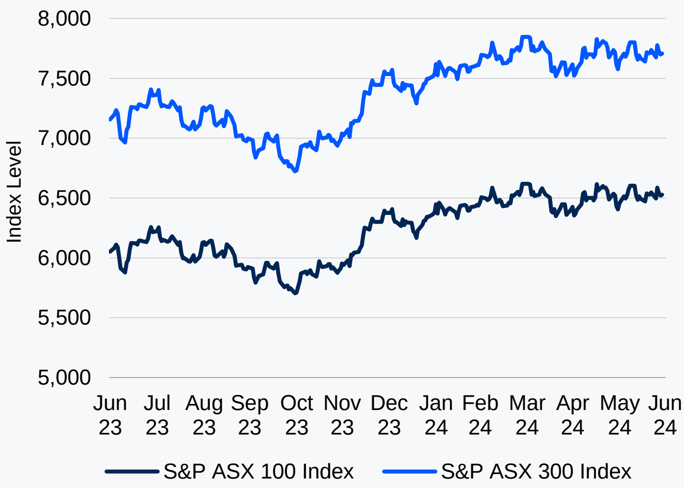
Australian Equities

Australian equities, and indeed most asset classes, experienced their first dose of volatility for 2024 early in Q2, as fears of 'sticky' inflation and diminishing hopes of rate cuts in Australia, pressured stocks in April. These concerns were primarily driven by hotter-than-expected inflation data, which reignited fears that the Reserve Bank of Australia (RBA) would be forced to hike rates after holding them steady since November last year. In Australia, the market is now 50 percent priced for the RBA to increase its cash rate target to a 12-year high of 4.6% in August, with cuts not currently expected until late 2025.

Despite positive performance in both May and June, the ASX 300 was unable to fully recover from the early-quarter losses, finishing the period down 1.2%. By market capitalisation, larger companies, as measured by the ASX 100 (-0.8%), outperformed small caps, as measured by the ASX Small Ords Index (-4.5%). Initially, higher bond yields in April weighed on smaller names, while later in the quarter, economic growth concerns further pressured smaller companies, which tend to be more sensitive to the economic outlook. From an investment style standpoint, Growth outperformed Value in the second quarter. Over FY24, on a total return basis, the ASX 300 returned 11.9%, which is above the 20-year average of 8.4%.

On a sector level, performance was mixed, with five of the eleven ASX 300 sectors finishing the quarter with positive returns. Utilities recorded the strongest gain (13.3%), followed by Financials (4.0%), Information Technology (2.4%), and Health Care (1.9%). In contrast, Energy (-6.7%), Materials (-5.9%), and Industrials (-4.3%) were the weakest sectors over the period. Their declines reflected growing anxiety about future economic growth, ongoing concerns around the property crisis and lower growth in China, and the potential impact of rate hikes on Australian households.

Figure 12: Australian shares - Large Companies



Source: FactSet, Perpetual Private

Australian Equities – Manager Insights and Outlook

It had already been a strong start to the 2024 calendar year, with the Australian share market surging to new record highs – up over 5% for the March quarter (and up over 14% for that 12-month period to end March 2024). With equity markets already having delivered returns well above historical averages and sustained buoyancy in markets having already priced in the broader optimism from investors that rate cuts may be getting close; we naturally approached the June quarter feeling somewhat cautious on the near-term path for equities. Entering this quarter, we had positioned the portfolio to be relatively neutral from a style perspective, with a balanced allocation to both Value and Growth managers. With greater economic uncertainty, we saw potential headwinds and tailwinds for both investment styles. On the one hand, stronger than expected labour markets with continued wage growth and falling unemployment rates sparked some concerns that rates may be kept on hold for longer than expected, or that we may even see a further rate hike. Against this backdrop we would typically favour managers with a 'value' style bias. On the flip side, broader economic data was signalling that rates may have peaked and the perceived stability in interest rates, a more resilient consumer and the possibility of near-term rate cuts, we also saw as potential tailwinds for managers with a 'growth' style bias. The portfolio also had a slight bias to SMID (small-to-medium) sized companies, as this is where we see stronger opportunities at more reasonable valuations, particularly given the strong run up in equity markets that we've seen more recently. At the sector level, key overweights were Tech, Healthcare and Consumer Discretionary stocks, while we remained under-weight other more cyclical sectors, these being Financials, Materials, Energy and REITs.

The June quarter commenced broadly as we had anticipated. April was notably a tougher month for Australian Shares, as higher than expected inflation data fuelled fears of a 'higher for longer' interest rate environment. This combined with escalating geopolitical tensions and some frothier valuations post the February reporting season all contributed to a more fragile 'risk off sentiment'. Whilst we saw share prices recover slightly through May and June, this wasn't enough to offset April's pullback. We saw weaker returns from Energy and Materials stocks, which was driven by several factors. Volatile oil prices weighed on energy stocks. Concerns over future demand and increased supply, coupled with higher input costs (i.e. labour, machinery, fuel, materials), and continued regulatory and environmental scrutiny of their operations, all continued to weigh on these sectors. Most notably it was the index heavy weights across these 2 sectors that were the biggest detractors – these being James Hardie (-23%), Fortescue (-17%), Woodside (-7.5%), BHP (-3.6%), Rio (-2%), and Santos (-1%). We also saw weaker returns from REITs (-6%), with the sector being more sensitive to interest rate expectations and higher bond yields. The portfolio's under-weights - Energy, Materials and REITS - contributed meaningfully to returns over the period. We have also seen broad-based resilience from the major banks, with the big 4 (NAB, CBA, Westpac and ANZ) plus Macquarie Group – who in aggregate represent close to 80% of the Financials sector – all delivering stable returns in excess of the broader ASX 300 index. The potential for rates staying higher for longer can be seen as a potential tailwind for banks, which can benefit from higher lending spreads. Other economic indicators such as continued tight labour markets and the strength of the consumer, helps loan demand and credit quality. The portfolio was under-weight the major banks, which was one of the primary detractors over the quarter, as was some of the smaller cap exposures in the broader portfolio.

As we look forward, we continue to remain cautious on the nearer term path for equity markets. We haven't yet seen a material pull back in share prices, and this is despite stickier inflation prints, tight labour markets and the resultant higher for longer interest rate expectations. From a valuation perspective, the Australian share market is broadly looking fully priced and in a relative sense, we believe there is still more opportunities and greater market inefficiencies outside of the larger cap index names. As such, our preference is to retain a slight bias towards SMID (small-to-medium) sized companies. At this stage, we don't have a strong conviction on whether the market will favour specifically Value or Growth stocks. The narrative from the RBA around inflation and the path of interest rates evolves month by month, and we could (and have) argued that there may be tailwinds for either style and as a result, we believe a relatively style neutral approach is warranted given the everchanging macroeconomic landscape. We believe this environment should bode well for fundamental bottom-up active managers, who can take advantage of any near-term volatility to deploy capital to companies at attractive valuations.

International Equities

International shares continued their positive run in Q2 2024, though momentum was tepid, with the MSCI All Country World Index (ACWI) delivering a 0.5% return in Australian Dollar (AUD) terms. In local currency terms, however, the index performed much better, achieving a 3.4% return. The ongoing strength of the A.I.-fueled tech rally, particularly in the U.S., was a key driver, with Nvidia adding 36% over the quarter and, at one point, briefly becoming the largest company in the world. However, sectors and markets not directly linked to the technology sector or 'A.I.' thematic generally experienced softer performance.

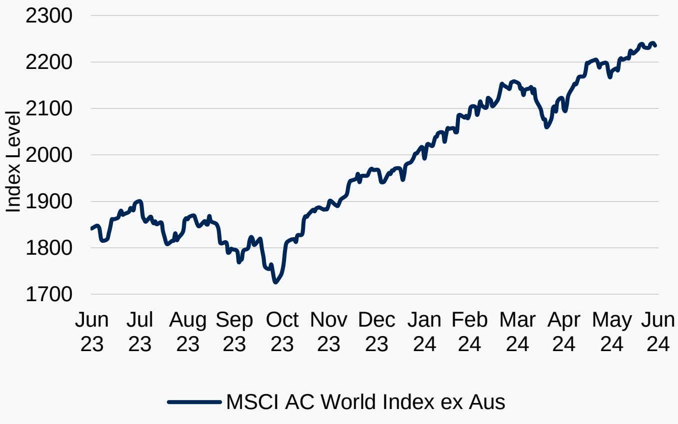
Large caps outperformed Small caps during the quarter, with the MSCI AC World Small Cap Index returning -3.8%, halting their early 2024 momentum as higher global bond yields in April and economic growth concerns later in the quarter weighed more heavily on smaller names. Unlike the broad rally seen in Q1, the past quarter saw lagging performance in the UK, Japan, and the Eurozone, highlighting divergent economic fortunes as the blend of and success in, taming inflation and maintaining growth, plays out at varying speeds.

From an investment style standpoint, Growth stocks outperformed Value, with Growth returning 3.5%[22] compared to Value's -3.9%[23]. Sector performance was narrow, with only three of the eleven MSCI ACWI sectors finishing the quarter in positive territory. Technology (+8.8%) and Communication Services (+5.6%) were the best-performing sectors, driven by strong earnings from A.I.-linked companies like Nvidia, Microsoft, and Amazon. Utilities (+1.2%) also posted modest gains, attracting investors with high yields and resilient business models amid rising economic growth concerns. In contrast, Energy (-3.1%), Materials (-5.4%), and Industrials (-4.1%) lagged, reflecting anxiety about future economic growth.

22 MSCI World Index Growth (Unhedged AUD)
23 MSCI World Index Value (Unhedged AUD)
24 MSCI Emerging Markets (Unhedged AUD)
25 MSCI EAFE (Unhedged AUD)

Internationally, Emerging markets (+2.6%[24]) outperformed Developed markets ex-North America (-2.7%[25]) in Q2, driven by renewed optimism toward Chinese economic growth and strong performance from A.I. exposed markets, Korea and Taiwan. Concerns about the timing and number of Bank of England and European central bank rate cuts, along with French and German political concerns, acted as headwinds over the period.

Figure 13: International shares (local currency terms)



Source: FactSet, Perpetual Private

International Equities – Manager Insights and Outlook

Last quarter, we spoke to how 'narrow' equity markets had been during Q1 2024. The continued enthusiasm for A.I. related stocks drove a large proportion of index outcomes during the quarter. For example, Nvidia reported sales and profits in May which were well ahead of Wall Street's expectations. This saw the stock rise 36% during the quarter, leaving it up 149% for the year. Furthermore, Nvidia has accounted for over 30% of the S&P 500's return in 2024. That said, increasingly we are of the view that global equity markets are too complacent. We say this for a few reasons:

1. The market appears to be wedded to the 'soft landing' narrative and the expectation of several near-term interest rate cuts. This explains the higher price-to-earnings ratios evident in markets at the moment, yet, at the same time macro-economic data has begun to weaken.
2. The market is focused on the growth prospects for the Information Technology sector, which has in recent months become an even larger component of commonly quoted indices. (Information Technology is now ~26% of the MSCI ACWI.) According to FactSet estimates, EPS for the MSCI USA Index is expected to grow 12.7% over the coming 12 months, while the Information Technology sector is expected to grow its earnings by 18.9% over the same forward period.
3. The market is not extrapolating themes permeating from the earnings season across the broader market, but rather assuming any negative news is solely specific to the company in question. Individual stock prices are reacting poorly to this news, resulting in material volatility below the surface.

To put these dynamics in context, here are a few anecdotes:

- Despite strong index level outcomes over the quarter, most stocks have been underwhelming in terms of performance. For example, the average stock within the S&P 500 is up just 4.1% this year, while the index is up over 14%. Furthermore, six of the eleven sectors in the S&P 500 delivered negative performance, including Financials, Energy and Industrials.
- Both the CBOE S&P 500 Dispersion Index, and our internal proprietary measure of 'dispersion', which measures cross sector volatility, had been moving lower up until recently. Recent weeks have seen this move moderate, and even tick up slightly. (A lower level of dispersion implies a greater number of sectors / stocks are moving in the same direction by similar amounts.)
- Markets are priced for perfection and even small misses versus guidance or lower than expected future guidance is being punished heavily by the market. For example, Salesforce fell ~20% upon the announcement of weaker than expected first quarter results, and Nike fell around 13% after it forecast lower revenue in CY 2025.

These big moves have typically been seen in companies which are more closely linked to the 'real economy', and indicate an increasingly two speed economy, whereby A.I. powered enthusiasm continues, yet consumers and businesses are increasingly judicious around their spending plans.

Given the dynamics outlined above and looking toward the coming period, we are focused on the nexus between valuations and revenue/earnings outcomes, particularly in the large and mega cap part of the market. As markets extend their rally, we consider corporate's 'margin for error' in terms of revenue and earnings outcomes to narrow markedly. Misses are likely to see the trend of sharp drawdowns on specific stocks continue. We believe that avoiding names where this risk is elevated will be key to delivering strong outcomes.

Finally, outside the large and mega cap part of the market we are seeing an increasing number of opportunities in sectors and regions which have not benefited from the rally to date. It is worth noting that these opportunities tend to possess greater 'relative value' when compared to other market segments, rather than 'screamingly cheap' in their own right (eg. Global Small Caps). As such, some exposure is warranted, but it remains too early to materially lean into these ideas.

Real Estate
(Listed property securities)

Volatility in bond markets and uncertainty around central bank policy action have been major drivers of the interest rate sensitive real estate market in recent times, and Q2 2024 was no different. Real estate investment trusts (REITs) are particularly sensitive to interest rates because higher rates increase the cost of borrowing and reduce the present value of future cash flows. Bond yields rose early in the quarter reflecting 'sticky' inflation and heightened concerns that central banks may need to tighten monetary policy, particularly in Australia and the US, where the interest rate environment is now assumed to be 'higher for longer'. With yields rising, both Australian REITs (A-REITs) and Global REITs (G-REITs) finished the quarter in the red.

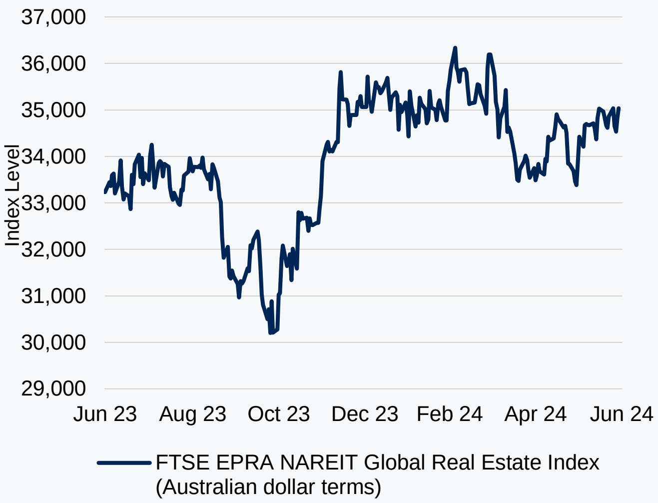
After being one of the best performing asset classes in Q1 2024, A-REITs gave back some of the gains in Q2, returning -5.6%. However, over FY24, their performance remains robust, returning 23.8%, largely due to the strong performance of Goodman Group, which received a boost from the rising demand of investors seeking exposure to data centres.

G-REITs, impacted by higher global bond yields and a stronger Australian dollar, returned -4.7% over the quarter. Their full FY24 returns have been much more muted compared to their domestic counterparts, returning 4.2%. Commercial office valuations continue to weigh on the index as low occupancy rates result from an increased shift to employees working from home. More defensive sectors like Residential, Self-storage and Healthcare were the best performers. All major regions finished the June quarter in the red in Australian dollar (AUD) terms, with Hong Kong and Japan being the biggest laggards. China's ongoing real estate woes, including a slowdown in property sales, high levels of developer debt, and continued regulatory crackdowns, have severely impacted the Hong Kong real estate market over the past several years.

Figure 14: Australian Real Estate Investment Trusts (A-REITs)

Source: FactSet, Perpetual Private

Figure 15: Global Real Estate Investment Trusts (G-REITs)



Source: FactSet, Perpetual Private

With rates the primary driver of sector returns over the quarter, we continue to see wide dispersion among sectors and regions. Performance in the U.S. was more muted than in other regions, as asset valuations have adjusted more quickly to the prevailing conditions and hence reflect more reasonable levels. Transaction activity remains light but we have begun to see some domestic sales with Dexus in particular disposing of its stake in three assets and QIC announcing its intent to sell a Western Sydney shopping centre, the largest retail transaction in 20 years. Sentiment around the impact of A.I., remains optimistic with data centre demand strong. This has been to the benefit of Goodman Group which has continued to outpace the A-REIT sector and Digital Realty in the US. Equinix should be a beneficiary but continues to face its unique challenges from the short-seller report issued earlier this year.

Equinix regained some of its 2024 losses after declaring that an internal audit had reaffirmed its financial reporting. Despite the rebound, the stock lagged the broader market and is likely to remain under pressure in the near-term. Prologis, the largest benchmark holding, sold off during April after lowering estimates for its 2024 earnings. The company is widely watched as a key U.S. industrial/warehouse operator and the announcement suggests that the sector is slowing as we alluded to last quarter. However, we will watch for further evidence and also note that any slowdown comes after a period of excessive rental growth that could not persist. At the other end of the spectrum, Goodman Group and Welltower benefited from positive sentiment on data centres and Healthcare respectively.

We expect dispersion to continue throughout the year. Office valuations appear to have further to fall but we continue to see relative strength in newer, more sustainable assets in prime locations. Rental growth is moderating, particularly among industrial companies. This trend is likely to persist through the year although we expect growth to remain positive. Retail has the benefit of constrained future supply but is highly sensitive to slowing consumer spending as persistent inflation bites. Lack of supply is also a characteristic of residential markets although key regions in the U.S. risk too much development. Rents are forecast to slow in parts of the Sunbelt and South, including Miami, Nashville and Phoenix, which have been destinations of choice in migration trends. We continue to expect real estate returns to be moderate this year and the prospect of a higher for longer rate environment is consistent with this view. The risks to this view are those of increasing rates as a result of a bounce in inflation or an economic recession with poor rental growth or rising vacancies, either of which could lead to a sell-off in the sector. An upside surprise may result from a decrease in rates coupled with mild economic conditions.

Alternatives

Growth alternatives

Traditional asset classes continued to rally through Q2 2024, while unlisted asset classes continued to exhibit more modest movements. In local currency terms contributors were Private Equity, Infrastructure, Other Growth Alternatives, and Hedge Funds. Opportunistic Property detracted over the quarter.

Demand for Infrastructure continues to soften, with a number of deals remaining in market despite repricing. Furthermore, we have observed an increase in fundraising activity by managers seeking to raise capital to buy Infrastructure secondaries. That said, infrastructure's role in the portfolio remains clear; to provide consistent and stable cash flows, and 'inflation hedging' properties. We are comfortable with our exposure to regulated assets and grateful for their contribution during the recent inflation spike. In the current sanguine macroeconomic environment, we are actively looking to increase exposure to volume-linked assets, with strong cash flow profiles that are able to deliver returns through the current environment.

Despite a modest pickup in merger & acquisition (M&A) activity in Q1 2024, the strength of equity markets and a hostile regulatory environment appeared to limit deal activity in Q2 2024. According to Dealogic, the number of deals signed during the quarter fell by around 21%, but volumes grew by just shy of 4%. What is notable is the pace of buyout activity led by private equity firms undertaking 'take private' deals. Deal activity in this space surged 41% to USD $286b in 1H 2024. Driving corporate activity, is a continued desire from shareholders for simpler businesses, as well as a modest uptick in activist activity. Despite the changing market dynamics, we remain steadfast in our approach to Private Equity, giving credence to acquisition valuation multiples, costs of debt and the manager's operational capability. (Notably, private credit capital raising has facilitated private equity deal flow, despite higher cost of debt.) On the latter, sponsors appear determined to invest in their operational capability to drive operating performance. We see further portfolio company valuation mark ups given the strength of equity markets and tradable comps.

Our investigations still detect turbulence within Real Estate markets. The market remains predominantly focused on the 'future of office'. Transaction volumes have picked up modestly, but in aggregate remain weak. We expect the magnitude of mark-downs to moderate in 2024, which should support deal activity later in the year and into 2025. Our focus remains on the nexus between availability of capital and valuations. We are seeing opportunities elsewhere in real estate markets. Increasingly we are seeing allocators who need liquidity, look to exit certain real estate funds at a discount to their prevailing NAV. The breadth of our relationships with real estate managers, positions us well to understand the underlying pool of assets, and underwrite these opportunities to attractive valuations / entry points.

We continue to see dispersion within equity and credit markets, as well as divergence in the macroeconomic regime facing many economies globally. This led to the funding of two new hedge fund investment in the prior quarter to complement our existing Global Asset Allocation and Credit-based exposures. We have been particularly pleased with our credit based exposures, which have materially contributed to performance on the back of tightening credit spreads over the last 18 months or so.

Changing market dynamics (inflation, path and pace of interest rates, softening across certain economic indicators) warrants continuous reassessment of our thinking, outlook and subsequently, portfolio positioning. During the quarter we made a new commitment to one of our incumbent private equity managers, New Mountain Capital. Our near-term pipeline is focused on a number of differentiated ideas which are uncorrelated to our existing exposures.

Income alternatives

Market sentiment remains broadly positive in Q2 2024. We have seen strong flows into private credit over the quarter; but demand has outstripped the supply of corporate debt. Despite a marginal pick up in M&A activity, deal levels remain below long-term averages.

Over the quarter, we have seen a marginal pick up in default activity and anecdotal evidence to suggest investors are becoming more discerning of credit quality. It is important to note this is more so in the smaller private credit transactions, compared to large corporate debt. For smaller private debt deals, we have seen improvements in underwriting standards as well as a marginal increase in spread. This is in contrast to large private debt deals where competition is fierce. Large corporate debt transactions continue to command a tighter credit spread as large supply of capital continues to chase increasingly smaller number of available deals.

Non-investment grade credit spreads have generally remained stable on average, but we have seen dispersion on a single name basis increase over the quarter. We attribute this to the refinancing activity which is happening alongside the higher interest rate environment. We have seen lenders impose stricter loan covenants and more disciplined asset valuations to the collateral. While positive for credit quality in general, this has contributed to an increasing number of debt-for-equity swaps. Going forward, we expect further increases in default activity as loan amendment (and extensions) expire.

Investor demand for private credit has also led to spread compression in the asset-backed debt space. Recently, we have seen more investor interest in private asset-backed assets which still command a higher relative spread for equivalent credit ratings. Positive flows into this segment is likely to continue if this environment persists. While yields are still attractive today, we expect them to fall in the second half of 2024.

On the public markets side, both US Leveraged Loans and US High Yield posted positive returns over the quarter. Despite some spread widening activity, total return outcomes remain supported by the income return which have risen in line with cash rates. US Leveraged Loan activity continues with increased demand driven by new CLO formation.

Private credit managers, as a business, have continued to flourish in this market. Traditional asset managers have been active in purchasing private credit businesses as an add-on to their existing capabilities. Valuations remains on the higher-end of the spectrum but is supported by the limited number of private credit businesses available for purchase. Additionally, we have seen increasing number of traditional banks participate in private credit however, more so in the capacity of deal structuring and loan servicing. Regulatory capital requirements and implicit return on equity targets continue to limit private credit exposures on balance sheet.

While supply of capital is supportive of the asset class, we have continued to deploy cautiously. We are less constructive on some segments of private credit given tighter spreads and uptick in default rates. Our research over the quarter focused on alternative forms of private credit. We have more recently funded an insurance "sidecar" which invests in a range of activities such as block annuities, flow reinsurance and pension risk transfers. We are also reviewing insurance premium funding with the view of deploying over the coming quarter.

Fixed Income

During the June quarter, Fixed Income returns were dominated by considerations of inflation, and by extension, interest rates. Of course, this isn't new. Such influence has been a pertinent feature of markets since the arrival of the pandemic in early 2020 and is always an important driver of financial assets more generally. Setting this period apart, is the simple fact that whilst many investors and economists had proclaimed "peak interest rates", a slowing in the progress of taming inflation dramatically reduced near-term expectations of interest rate cuts.

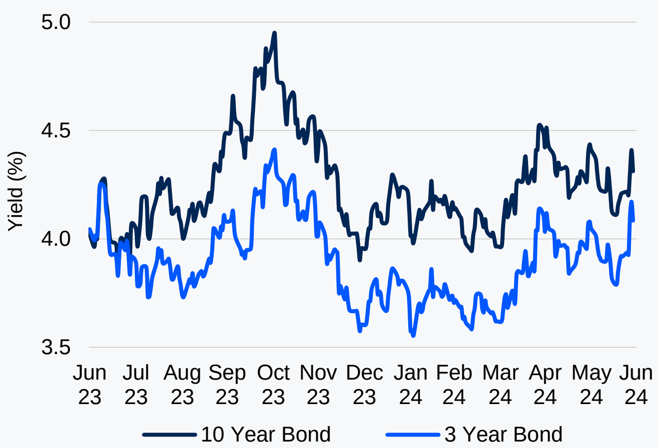
If we step through the past three months, yield curves in both the U.S. and Australia, made meaningful parallel shifts upwards in April, before stabilising and partially settling back through to June. These movements reflect the growing probability of further rate rises, effectively demonstrating just how challenging the battle against inflation is proving to be.

Considering these moves in the context of our global bond benchmark, the Bloomberg Global Aggregate, we see a negative return of 0.14% for the three months, benefiting from a relatively strong outcome in June (0.77%). Domestically, the experience was similar, with a negative return for the quarter (-0.50%[26]) and a buoyant June (0.39%).

Credit markets, with their lower duration and higher nominal yields, enjoyed somewhat better outcomes. In Australia, this lead to a positive return of 0.23% for Credit[27]. Here, despite being less impacted by higher expected yields, a widening of credit spreads acted as a dampener on the return. Casting our attention to an area of the market that has both minimal duration and credit, Bank Bills, we saw one of the most robust outcomes in the asset class, with the AusBond Bank Bill index delivering a healthy 1.08% return for the period.

Outside our primary focus of Australia and the U.S., the European Central Bank became the first major central bank to cut their cash rate target (0.25%), after the significant and rapid monetary tightening that was deployed in 2022 and 2023. Whilst this cut was telegraphed and somewhat guaranteed to the market in advance, it was not the positive catalyst many had hoped, because the messaging around it was delivered in somewhat 'hawkish' terms. Here, despite relative softness in the European economy, sticky inflation led to caution around the future path of interest rates.

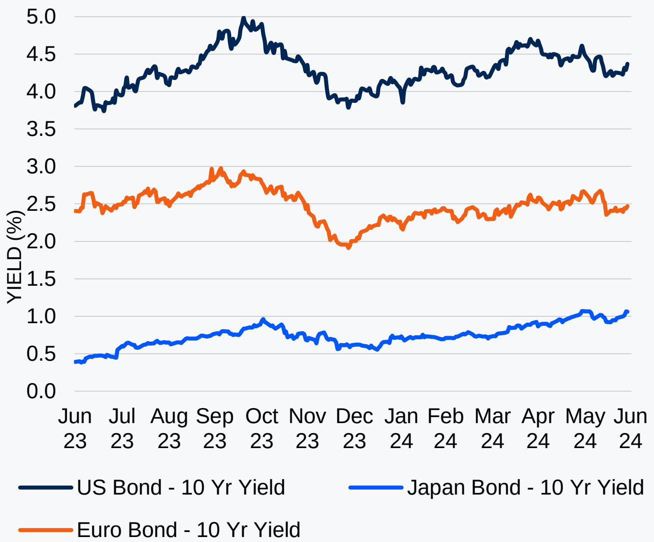
Figure 14: Australian government bond yields



Source: FactSet, Perpetual Private
Note: Bond prices are inversely correlated with bond yields.

26 As measured by the Bloomberg Ausbond Composite
27 As measured by the Bloomberg Ausbond Credit

Figure 17: Global government bond yields



Source: FactSet, Perpetual Private

Figure 18: Global credit markets

Source: FactSet, Perpetual Private

Fixed Income – Manager Insights and Outlook

Our outlook on inflation last quarter proved prescient as headline inflation in Australia and the U.S. came in above 3%. The spectre of inflation staying higher for longer was priced into the market over Q2 2024; resulting in rising yield curves. Over the short-term, direction of inflation prints remain hard to predict and to add complexity to the current environment, central banks have continued to indicate to the market that they remain largely data dependent. This has led to oversized market reaction to short-term economic data whilst largely ignoring central bank commentary.

Our review of the current environment over Q2 2024 suggests that inflation will likely moderate but over a more extended timeframe than currently anticipated by markets. Consumers both in Australia and globally have continued to be affected by the current environment; as is evidenced by continued drawdown in savings and increased borrowings. Across the age groups, this has had a higher impact on consumers between 25 to 45 years of age. Domestic labour markets have remained resilient over the last quarter but wage growth has moderated. This compares with the U.S., where there are some signs of labour market weakness, but it remains too early to tell if this trend will persist.

Companies have been more active issuers of credit in 2024 compared to 2023. Supply of credit continues to be met with strong demand. Higher all-in yields relative to the last 10-years continue to incentivise capital formation. Corporate default rates while elevated, are not excessive; and have remained steady over the last quarter. Since the beginning of 2024, we have seen continued demand for credit across peer portfolios and this has resulted in spread contraction over the period. More recently, we note that investors have become more discerning on credit quality, rewarding companies who continue to generate earnings growth in this environment. For companies with weaker earnings profile, we have seen an increased credit spread (i.e. increased cost of debt).

From a macroeconomic risk perspective, we continue to see stagflation as a potential risk on the horizon. A period of weak (or negative) growth with higher inflation will likely limit the ability of central banks to stimulate the economy via interest rate cuts. We have seen some market commentary on stagflation risks but this has not been priced into the markets. Credit valuations at current levels generally reflect a bullish investment environment.

From a portfolio perspective, we remain broadly neutral on rates; noting that higher inflation while negative for rates over the short-term may give way to an economic downturn which is positive for rate positions. In balancing the two potential outcomes, we continue to maintain a neutral position. Specific to credit we continue to keep our risk budget relatively low, leaning into exposures with shorter maturities which benefit from the high cash rate.

Australian Cash Rate

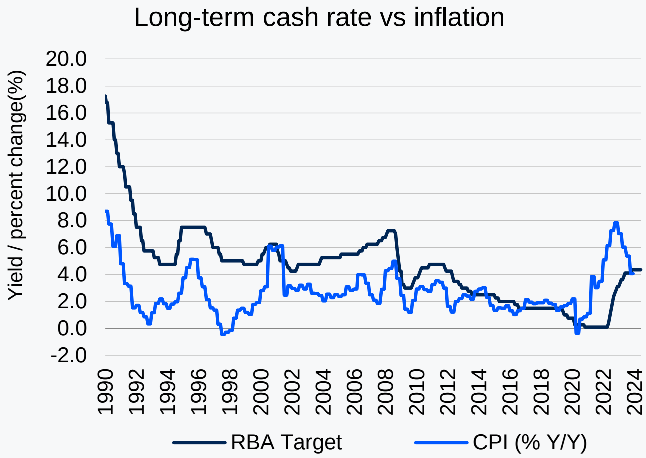
In the lead up to the end of Q2 2024, the cash rate in Australia has been maintained by the Reserve Bank of Australia at 4.35%, a position that hasn't moved since it was raised from 4.1% in November 2023. Whilst inflation has fallen substantially since its peak in 2022, its pace of decline hasn't matched the RBA's required pace for them to start cutting rates. This is primarily due to excess demand and consumer spending surprising to the upside, causing inflation to remain 'sticky'. Inflation expectations have fluctuated over the three months but have settled higher than last quarter at 4.4% which will likely give the RBA some further cause for concern as the path forward has become less clear. Governor Michelle Bullock said in the latest RBA board meeting that "earlier on, when [we] were raising rates, it was quite obvious what we had to do. It's not so obvious now."

Australian Cash Rate Outlook

In meeting minutes released by the RBA in June, the board adopted a more hawkish position then previous months, with Ms. Bullock commenting that "the evidence on inflation is that it is telling us that demand is still a bit too strong." Previously, the RBA had signalled that the next rate change would more likely be down than up. However, this now appears to be less likely as investor's expectations for interest rate cuts have been pushed out to next year. We are now seeing the market price in a rate hike in the August meeting, with the June CPI print (to be released on July 31st) being a vital data point in determining which direction the RBA will move. Ms. Bullock has made it clear that this information will help inform the board as to whether the uptick in inflation to 4.0% in May was a true reflection of inflationary pressures. This is not to say that a rate hike is now a foregone conclusion, only that the RBA has stated clearly that they intend to keep rates high until inflation comes firmly back within control.

At this point in time, peers such as the U.S. Federal Reserve are expected to start cutting rates at least once before the end of the year as data suggests that inflation is on track to meet their 2.0% goal. Minutes from the most recent Fed meetings echo this sentiment with the committee using language which indicates that they will begin cutting rates once they have full confidence that inflation is firmly under control. Elsewhere, services price inflation has generally come in softer-than-expected, with central banks in the Eurozone, Canada and Sweden already having cut rates.

Figure 19: Australian long term interest rates

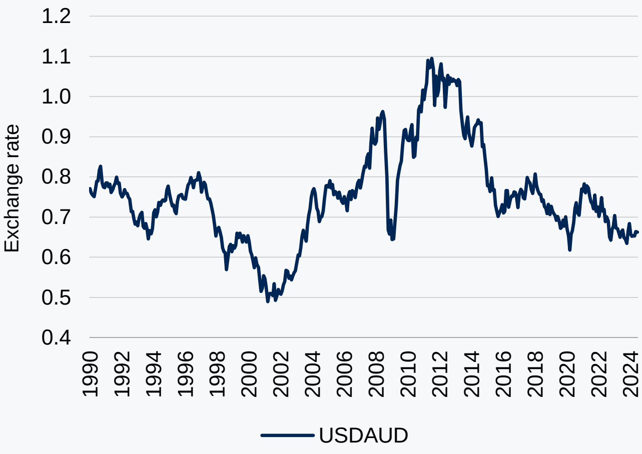


Source: FactSet, Perpetual Private.

Australian Dollar

After beginning the year at a high of 68 cents (per 1 AUD), the Australian dollar has seen a steady decline against the greenback (U.S. dollar), reaching a year-to-date low of 63 cents in April. Since then, it has strengthened to 67 cents. The Australian dollar followed a similar path against the Chinese Yuan, beginning the Q2 2024 at a calendar year low of 4.89 Yuan (per 1 AUD) and finished at 4.91 Yuan. Finally, the Japanese Yen has weakened against most of its major peers including Australia, due Japan's low interest rates.

Figure 20: Australian dollar U.S. dollar (daily) long term



Source: FactSet, Perpetual Private.

Australian Dollar Outlook

We typically refrain from adopting near-term forecasts on the Australian dollar. Recognising its susceptibility to trade flows and momentum, short-term predictions can be challenging. Nonetheless, looking ahead over the medium to long term, we anticipate the AUD will rise over the next year.

On a long-term purchasing power parity basis, the Australian dollar (AUD) appears undervalued in our view, suggesting there is potential for the currency to appreciate. This potential is further bolstered by the expectation that the RBA will be more 'hawkish' than its global peers, creating a more favourable interest rate differential for the dollar. Furthermore, Australia's role as a major commodity exporter could benefit significantly from rising commodity prices, as countries onshore key industries and accelerate their push to clean energy. Finally, Australia's robust current account position compared to past decades provides a strong foundation for the currency's future growth.

Authors

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Andrew provides investment research, portfolio construction and bespoke investment advice for Perpetual Private's clients.

Andrew works closely with advisers by providing specialist investment knowledge on Perpetual's investment process and strategy implementation, focusing on delivering optimal solutions to our stakeholders and partners. This is further augmented by his provision of transparent and accessible knowledge of financial markets and asset classes both globally and locally.

Having spent 15 years in London, Andrew returned to Melbourne with a wealth of international experience to benefit Perpetual's clients and partners. Having started his career working on private equity transactions and stock market listings, he then spent time working on equity trading desks, before moving into investment management. In his role as a Portfolio Manager for Barclays Investment Solutions, Andrew managed money across multiple asset-classes on behalf of various client groups, before focusing on the charity and not-for-profit segment. With responsibility for as much as £3bn in assets, he developed a strong reputation for delivering robust investment performance linked to his comprehensive understanding of global investment markets.

Andrew is a holder of the Chartered Financial Analyst and the Chartered Alternative Investment Analyst designations

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Hugo joined Perpetual Private's Investment Research Team in October 2023 as an Investment Associate. In this role, he primarily supports the Head of Managed Accounts and Perpetual Private Investment Directors through the creation and ongoing maintenance of investment content and collateral. Additionally, he assists in communicating the Perpetual Private investment offer to advisers and intermediary sales on behalf of the Multi-Manager and Direct Equities teams.

Prior to joining Perpetual, Hugo spent four years working overseas in Vancouver, Canada for a wealth management firm as a Research Analyst. In this role, he primarily focused on the strategic and tactical asset allocation of the firm's High Net Worth client base, across a broad range of asset classes and client profiles. Prior to that, he held roles in Sydney at BT Financial Group as a Customer Relations Consultant and TP ICAP as a Trainee Broker.

Hugo is a CFA charterholder with a Bachelor of Commerce degree, majoring in Finance and Accounting, from the University of New South Wales.

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