ESCALA
PARTNERS

AGENDA 2024

Chief Investment Office

Welcome

Pep Perry
Co-Chief Executive Officer

Torty Howard
Co-Chief Executive Officer
(Appointed December 2023)

Welcome to the fifth edition of our annual investment publication, Agenda 2024. This publication is compiled by our investment team headed by our Chief Investment Officer, Tracey McNaughton.

The futility of writing an annual outlook does not escape us.

We don't really know what is going to happen in the coming twelve months – nobody does. The past four years have featured unforecastable events that have been central to the performance of financial markets. The outbreak of coronavirus in 2020; the early COVID-19 vaccine discovery in 2021; the fragility of global supply chains in 2022; and the resilience of Western consumers in 2023.

It is with this mindset that we say, anything is possible in 2024.

As investors, we need to work with probabilities, not possibilities. On this basis, equity markets are likely to go up. As our Asset Class Quilt shows, negative annual returns are rare – just four instances in the last 20 years. In 2008 and 2011 the cause was the global financial crisis and the European debt crisis. In 2018 and 2022 it was higher interest rates. A financial crisis is not in our forecast and interest rates have likely peaked.

More interesting for us, as longer-term investors, is to use this time to gauge where we are from a thematic perspective. Big tech was the winner in 2023 while clean energy was given the wooden spoon. It would be unwise to dismiss clean energy as an investment, just as it would be unwise to load up on Nvidia. Investment themes by their nature extend beyond a 12-month investment horizon. Thematic change happens gradually, then suddenly.

So, while you will find in these pages our views on where equities, interest rates, real assets and currencies are heading in 2024, the more relevant focus is our views on how the tectonic plates that underpin financial markets are shifting.

Global order is changing before our eyes. The implications for investors are more subtle and nuanced than simply saying "buy gold". Governments are adapting to the rise in identity politics. The need to please a diverse voter base is leading to a depletion of political capital, retarding economic reform and turning policy makers inward. Governments are getting bigger; productivity and potential growth are getting smaller. This is the environment within which long-term investors need to make their decisions.

For us, this means private over public markets; alternative over traditional assets; active over passive investments. And, as always, the best investment strategy is one that embraces diversification. The best diversification strategy is one that is soundly based on process. The best process is one that is devoid of emotion. As Howard Marks would say, you can't predict but you can prepare.

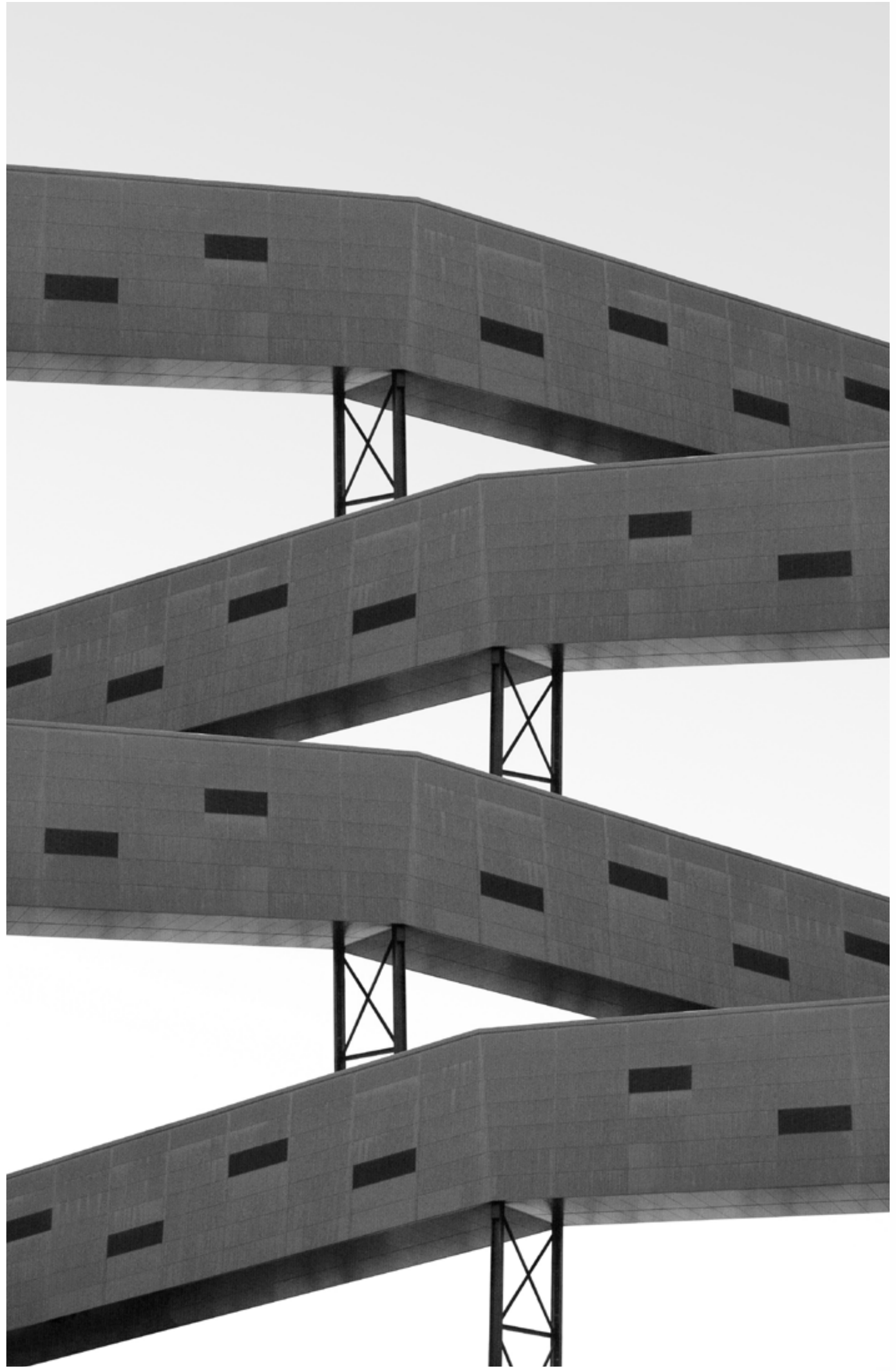
We hope you enjoy Agenda 2024. We look forward to continuing the conversation in the months and years ahead.

Escala Partners Pty Ltd

Melbourne
Level 19, 90 Collins Street
Melbourne VIC 3000 Australia
T 03 8651 2600

Sydney
Governor Macquarie Tower
Level 25, 1 Farrer Place
Sydney NSW 2000 Australia
T 02 9102 2600

information@escalapartners.com.au
escalapartners.com.au



Contents

Our Views in Short

Global Growth

Growth is expected to slow in 2024 as unemployment rises and consumers pull back. Liquidity will continue to contract as major central banks shrink balance sheets further and interest rates, while lower, remain above neutral.

Inflation

Inflation is expected to continue its downward trend on fading energy pressure and weaker labour markets and as the delivered monetary tightening starts to weigh on the growth outlook.

Interest Rates

The fastest and most synchronised developed market central bank tightening cycle of 2022–23 will begin to reverse in the first half of 2024 against a backdrop of muted growth and falling inflation.

Fiscal Policy

Fiscal policy should be slightly contractionary in 2024, reflecting a bit of belt-tightening on the spending side partly offset by higher interest outlays on government debt.

Bond Yields

We look for lower yields and steeper curves in 2024. Australian bonds are more attractive than their global peers given the greater risk of recession in Australia.

Equities

2024 looks like a year of slowing nominal GDP growth as inflation recedes. Reasonable earnings growth and single-digit returns are expected. Investment flows into and out of the asset class will create volatility.

Currencies

The year ahead for the U.S. dollar is likely to remain bumpy but elevated. Heightened geopolitical risk will be a key support. If rate cuts are realised, the dollar would still yield more than 56% of global currencies on a real basis.

Alternatives

Alternatives offer the best risk-adjusted return for investors in 2024. Investment flows will be more moderate creating a more stable backdrop for investors. Deal flow and fundraising environment will remain challenging. Our preference remains for private debt in a soft-landing scenario.

The Age of Uncertainty

Tracey McNaughton
Chief Investment Officer

According to *Foreign Affairs* magazine we are in an "Age of Uncertainty."

This uncertainty comes in multiple forms. The threat of war on many fronts including with Russia, China, Iran and North Korea. The threat of crisis stemming from ageing demographics, a warming climate and excessive debt burdens. And the threat posed by rapid, uncontrolled and unregulated development in advanced technologies.

76

The number of countries scheduled to hold elections in 2024.

The Economist

Adding to the level of uncertainty in 2024 is the number of elections that are due to be held where contrasting ideologies will be contested. It will be the biggest election year in history, with half of the world participating across 76 countries in regional, legislative and presidential elections.

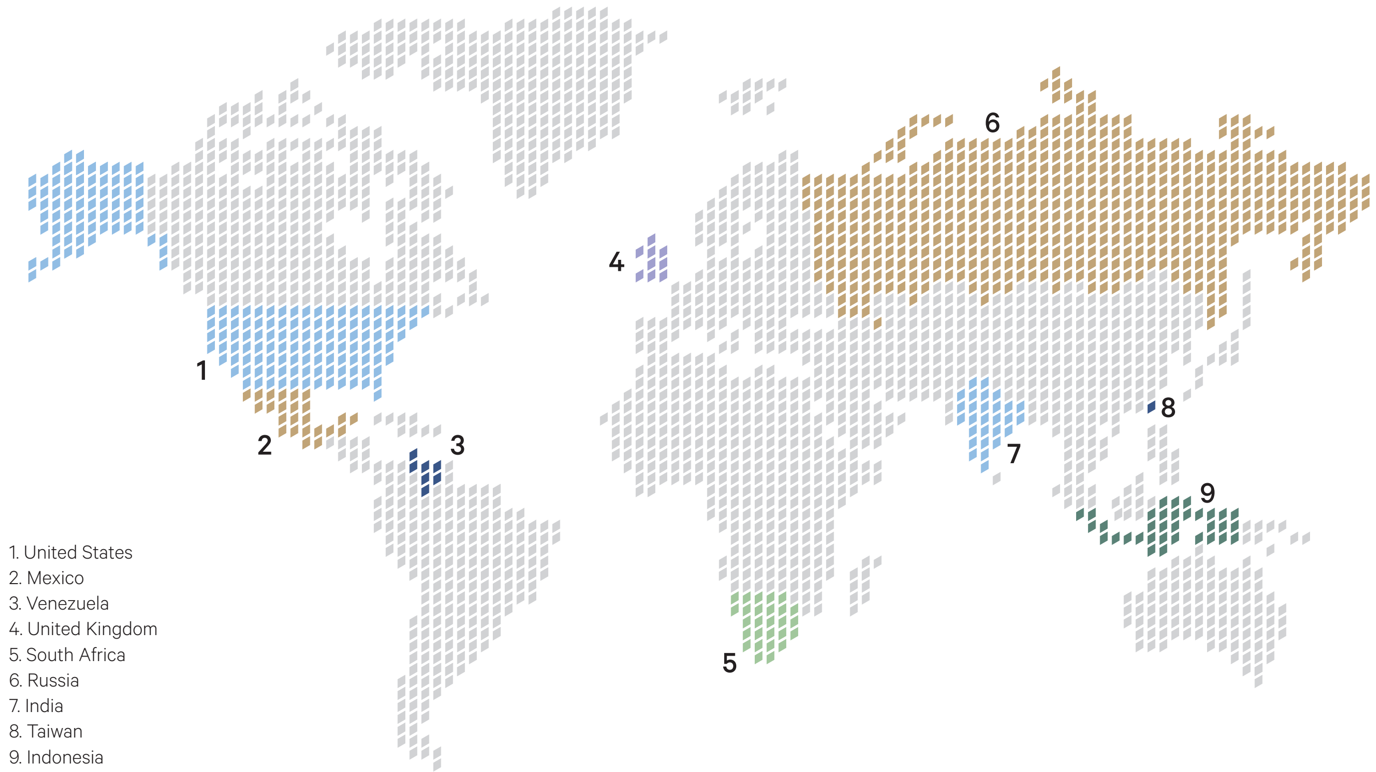
Complicating the situation is a growing mistrust in the integrity of elections themselves, as well as the potential for online misinformation during the campaign. In some countries, there is a widespread risk of doctored results or mass protests in response to them. At worst, it has the potential to be poisonous and polarising. At best, it will be a distraction and add to the level of uncertainty.

The year of the election will begin in Taiwan in January and end in the United States in November. Both will help shape US-China relations over the next few years. A Trump victory in November, assuming he is the Republican nominee, plus a Republican sweep in Congress, could bring substantive policy changes and with it America's role in the new world order.

In between are the European Parliamentary elections in June. Given the relatively high polling numbers for the far right across parts of Europe and the recent Dutch result, this election could test the capacity of the traditional mainstream parties to maintain a majority and the Commission's ability to push further EU integration, such as with the "open strategic autonomy" agenda.

Against this backdrop, we've adopted a probability-weighted, scenario-based approach to forecasting macroeconomic and market outcomes. We're taking this approach for two reasons. First, to avoid over-reliance on a single base-case scenario and the false precision of point forecasts particularly in the current environment. Second, to incorporate a sense of humility into forecasting by forcing us to imagine a full distribution of potential outcomes.

Some of the more noteworthy elections in 2024



Source: Escala Partners

Soft Landing (40%)

Policymakers achieve the impossible. Real growth remains resilient near or even above trend levels supported by easy financial conditions, while inflation converges decisively towards central bank targets. Banking woes ease and the labour market softens but remains robust enough to continue to support consumption. The US cuts interest rates as inflation cools and growth remains resilient. Favourable environment for interest rates and risk assets. Technology, small cap stocks and real estate benefits.

1,200%

The rise in Nvidia's profits in the past year.

Bloomberg

Recession (30%)

Rarely do policymakers bring down inflation without causing a recession. The labour market runs out of steam, denting income and spending just when the combined weight of the fastest and most aggressive tightening cycle in four decades and depleted stimulus savings begins to mount. Unemployment rises rapidly and inflation falls, leading to a substantial easing cycle starting in Q2 2024 and extending to below neutral rates.

Defaults rise, credit markets deteriorate. Risky assets correct lower, defensive sectors such as consumer staples, healthcare and utilities outperform cyclicals such as consumer discretionary, financials and materials. Longer maturity bond yields fall.

The Age of Uncertainty (contd.)

Stagflation (25%)

Tight monetary policy weakens growth to just above flat. Meanwhile, the labour market and real wages remain solid enough and fiscal conditions supportive enough to keep services inflation too high and persistent for central banks to reduce policy rates significantly.

Risk assets are patchy with defensive sectors outperforming cyclical sectors. High inflation prevents longer-maturity yields from falling.

Roaring 2020s (5%)

U.S. growth accelerates above trend, supported by high productivity growth as the dividend of public investments, and the diffusion and commercialisation of artificial intelligence and other technologies becomes widespread. Consumers are supported by the wealth effect from higher house and equity markets. Inflation drops rapidly as productivity gains ease labour shortages and generate a positive supply shock, allowing central banks to ease policy towards a neutral stance. All financial assets perform strongly.

10%

The share of global GDP allocated to healthcare.

World Health Organisation

The challenge for investors is what is already priced in. The final three weeks of 2023, spurred on by growing confidence in the ultimate soft-landing scenario, was responsible for almost half of the total returns for Australian equities over the year and almost 20% of the total returns for US equities.

On this basis, it is hard to argue the soft-landing scenario is not already priced in. This means to get even better returns in 2024 we would need to start encroaching on the low probability Roaring 2020s scenario. Sounder heads would suggest 2024 is going to be all about protecting the gains already made and resisting the temptation to take too many tactical tilts.

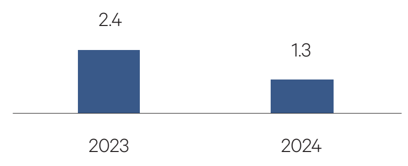
Picking the eyes out of this market will require a deft active manager's hand while a position in private markets will provide some protection from any politically-induced volatility.

Global Economy Breakdown

United States

US economic growth will ease following a surprisingly strong 2023. Surplus COVID-19 savings have depleted, monetary policy is less easy and fiscal policy is less supportive. A weaker labour market will see consumption pullback and inflation continue to ease.

GDP %



Europe

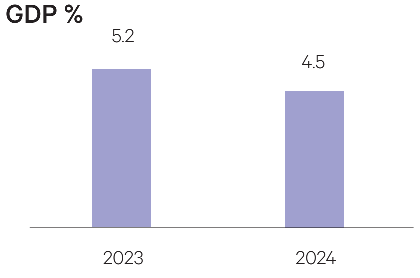
Real GDP growth in the euro area is expected to remain weak in 2024. Countries with a high proportion of industrial production, such as Germany, must expect lower growth on the back of a still soft outlook for China and rising trade protectionism.

GDP %

China

We remain cautious on China in the coming year, with a high downside risk driven by the property sector. The correction in the real estate sector is likely to continue in 2024 and weigh on investment, household consumption and local government finances. Fiscal support is limited by already excessive levels of debt.

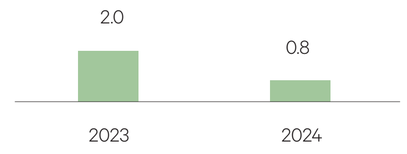
GDP %



Japan

The Japanese economy is expected to decelerate in 2024 on the back of slowing domestic and external demand. Softer growth in the US and China will weigh on exports, which will also slow manufacturing. On the back of growing economic uncertainties, companies are expected to limit their investment.

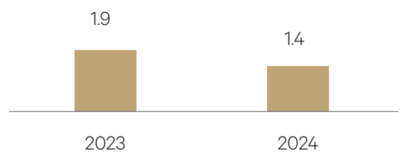
GDP %



Australia

Higher interest rates will slow the economy in 2024. Employment growth is expected to remain positive, but the unemployment rate will move up. A slowdown in net migration will help restore some balance to the housing market. Consumer spending and inflation will decelerate.

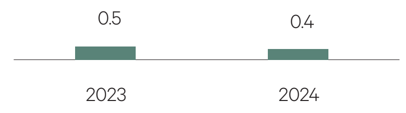
GDP %



United Kingdom

Real (inflation adjusted) disposable income is set to improve as inflation falls but wage growth remains elevated. Fiscal policy is likely to weigh on growth as the government's COVID-19 and energy support measures continue to unwind.

GDP %



Source: Bloomberg, consensus data as at 31/12/23

Theme 1: De-carbonisation

Darragh Kennelly
Investment Analyst

Reducing global greenhouse gas emissions to net zero by 2050 will require a herculean effort that needs a complete overhaul of global energy and industrial production and investment in innovation such as carbon capture technology. In total, the cost is estimated to be $9.2 trillion per annum over the coming years.

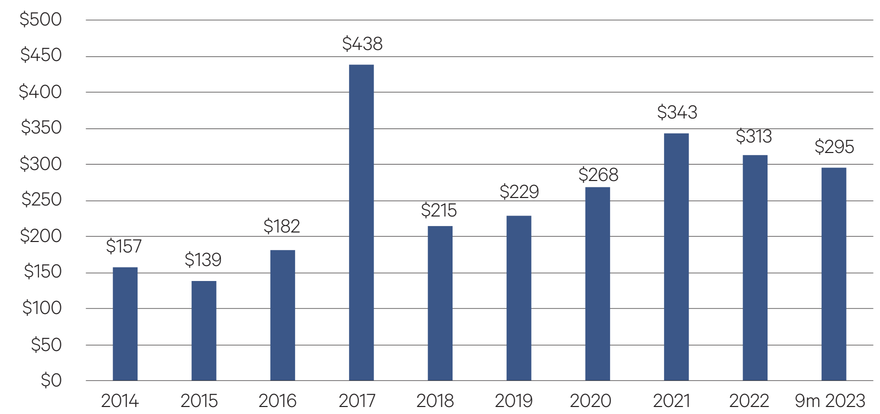
The expense will be inflationary, at least initially, as demand for the limited supply of critical resources, such as copper, zinc, and lithium, intensifies. Redesigning and rebuilding existing infrastructure will also be costly as labour and materials are redirected from other areas of the economy. Rebuilding a flooded warehouse does not add to the productive growth of the economy. The impact on the supply chain from climate events will also create supply-demand imbalances which can lead to higher levels of volatility and investment uncertainty.

One of the biggest burdens of climate change rests with insurers. The frequency and magnitude of severe weather events has set records every year for over a decade. Global catastrophe losses for 2023 are estimated to be above $300 billion for the third consecutive year. Insurers face increased payouts and claims due to extreme weather events. Insurance premiums are rising rapidly as a result.

The physical risks associated with a warming planet are both acute (hurricanes, floods, droughts, wildfires) and chronic (impact of gradual temperature rise and sea level rise). The implications for critical infrastructure and labour productivity are clear. Aside from the obvious threat to physical assets in flood events, heatwaves can potentially cause major disruptions to data centres, the critical IT infrastructure that underpins our daily lives.

In 2022 heatwaves caused outages to data centres for Google, Oracle and Twitter. The potential loss of revenue for data centre operators could run into the billions without significant investment into better heating and ventilation, more energy efficient hardware and software, and more independent renewable energy sources.

Economic cost of weather event $ billions



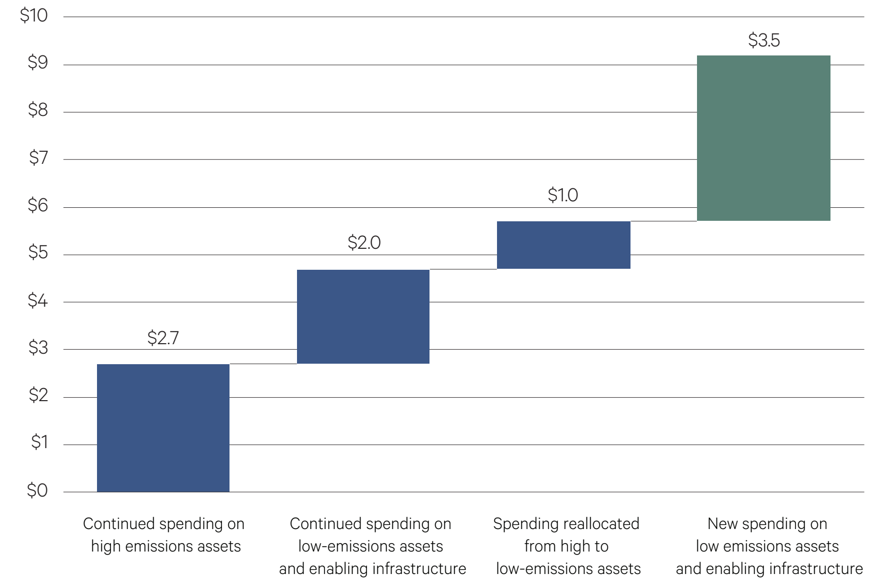
Source: AON, Bloomberg

>US$300bn

Catastrophe losses for 2023.

AON

Estimated annual spending required in a Net Zero 2050 scenario (US$trn)



Source: AON, Bloomberg

Current spending on green initiatives is $5.7 trillion. This is still $3.5 trillion short of the $9.2 trillion annually required to achieve net zero by 2050. In the US alone the funding gap is $1.3 trillion. As part of this, spending and investment patterns will change with greater investment in new low emissions across energy, transportation and buildings.

35% p.a.

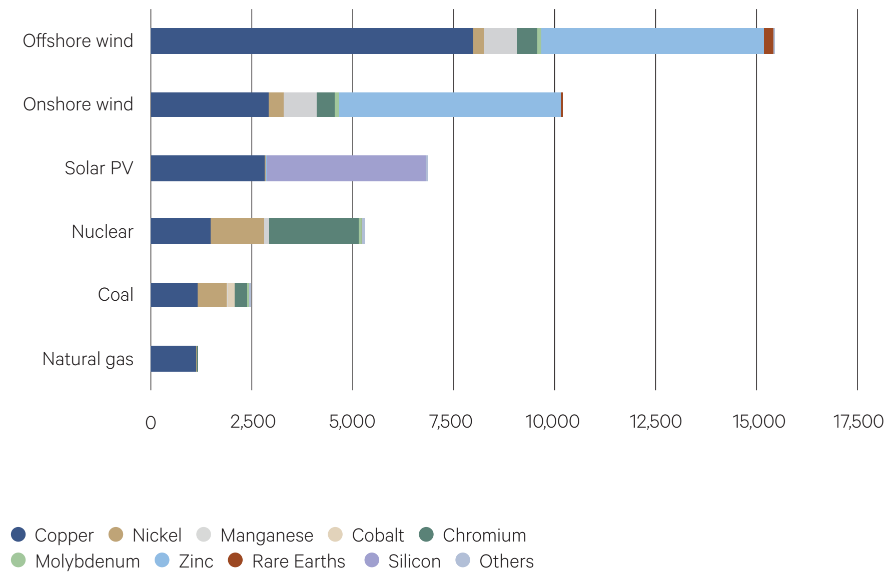
The increase in energy transition investment required in the US to close the funding gap.

McKinsey Global Institute

To achieve net zero, we need exponential growth in existing and new climate technologies. Wind and solar power generation would need to grow 6-fold and 14-fold by 2030 from 2021 levels respectively, whilst the number of EVs sold would need to increase by a factor of 14. All of this will require a massive amount of raw materials. Forecasts show that many critical raw materials will be in supply deficits by the end of the decade which will drive commodity prices higher.

These changes will be gradual and require patient capital. For this reason, we believe private markets investments, with longer time horizons, are best placed to capitalise on this. Specifically, alternatives such as unlisted infrastructure investments will see a significantly growing pipeline of opportunities over the coming years in renewables, energy grid infrastructure upgrades and buildouts, and EV charging infrastructure.

The transition to a renewable economy will require far greater critical raw materials (kg/MW)



Source: IEA

1400%

The estimated increase in solar power generation by 2030.

McKinsey Global Institute

Theme 2: De-risking Supply Chains

Stephen Dickinson
Investment Analyst

Since 2020, many macro events have contributed to reveal the fragility of the global supply-chain. This includes the COVID-19 pandemic, the Russia-Ukraine war and growing geopolitical tensions. As leaders and businesses look to build more resilient supply chains, the trend toward onshoring, nearshoring and friendshoring is gaining traction.

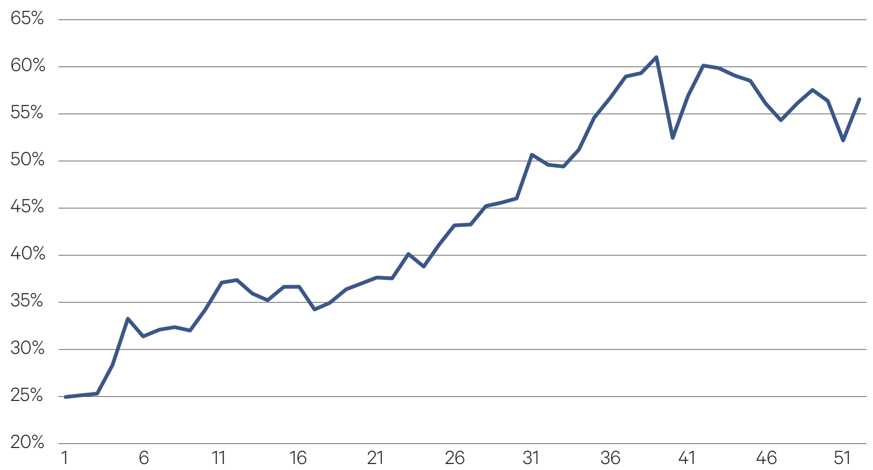
In this new era of “de-risking” and at a time of geopolitical tensions with China, each of the G7 nations have committed to lessening their reliance on China. This process has already begun. For example, US foreign direct investment in China fell 61% from a peak of $20.9bn in 2008 to an 18-year low of $8.2bn in 2022.

61%

The decline in US foreign direct investment in China.

Financial Times

World trade as a share of global GDP



Source: Our World in Data

There’s no place like home

Increasingly, companies are considering “onshoring” due to the fragility of global supply chains or more favourable trade policies in the home country.

In the US, recent legislations – the Inflation Reduction Act, the Infrastructure and Investment Jobs Act and the CHIPS & Science Act – are all supportive of the development and investment of recent technologies.

The semiconductor industry is a case in point of a critical sector using onshoring and nearshoring to gain supply chain security.

Geographically close and politically aligned

“Nearshoring” in the supply chain refers to the practice of outsourcing business processes or services to companies located in neighbouring countries.

By 2035, 45% of supply chains are expected to be mostly autonomous, utilising automation such as robots in warehouses. The growth of automation may well reduce the necessity to offshore production to countries that offer lower labour costs.

45%

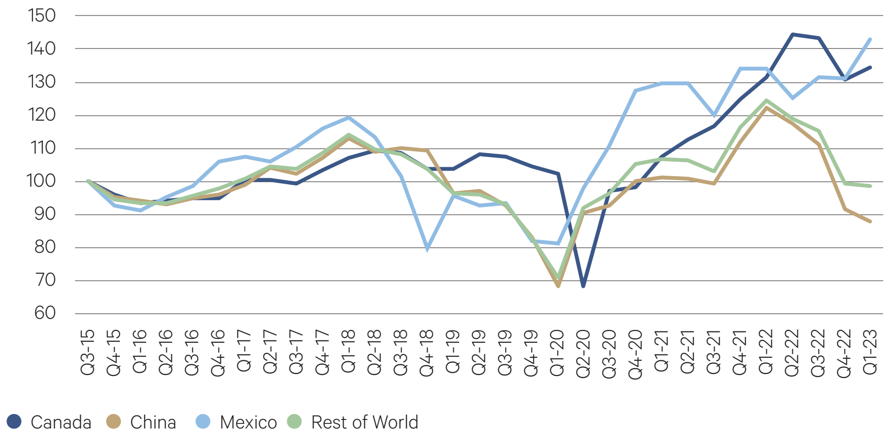
of supply chains are expected to be autonomous by 2035.

Macquarie Bank

Friends and partners

“Friendshoring” is a new concept coined by the Biden administration in which countries source raw materials and manufactured goods from other countries that share their economic and political values. One of the most recent examples of friendshoring is the Indo-Pacific Supply Chain Resilience Initiative, launched in April 2021 to share knowledge on supply chain resilience.

Total US trade with major trading partners (Index 2015=100)



Source: Federal Reserve Bank of Dallas

Globalisation has peaked, but deglobalisation is in its early stages.

TS Lombard

A new wave of re-industrialisation

A byproduct of a world that is becoming more regionalised and increasingly polarised may turn out to be a new wave of re-industrialisation. It started in the US with Bidenomics, the basic plan - to rejuvenate domestic industrial hubs, reorient (or “de-risk”) global supply chains and transition to new clean energy sources.

Europe, facing pressure to protect its domestic car industry from Chinese EVs and find an alternative to Russian natural gas, has no option but to respond. Similarly, Japan and South Korea have introduced subsidies for their tech and clean energy sectors.

All of this supports the thesis for continued deglobalisation, with the start of a new era of strategic industrial rivalries.

Investment implications

Onshoring will require years of sustained investment. Private markets are the likely beneficiaries. To manufacture efficiently requires reliable infrastructure as governments prioritise self-sufficiency and security. Onshoring will provide tailwinds to construction and engineering firms, railroads and consumer discretionary firms. Changes to the global economy are widening the scope for future infrastructure investment strategies.

A trend towards onshoring of supply chains is – and will continue to be – an additional driver of demand for select industrial property markets.

Within private equity, industrial technology will likely provide attractive opportunities as the sector moves to become less-labour intensive and more tech-enabled.

Theme 3: De-fence

David Bruty
Investment Analyst

Investors have recently been grappling with a rapidly changing environment as COVID-19, inflation and higher interest rates have transformed the landscape. An increasingly fragile geopolitical picture has also emerged, adding another complex layer in which to navigate.

In 2022, it was the Russian invasion of Ukraine that dominated the headlines. In 2023, it was the escalation in conflict between Israel and Hamas. Of course, these conflicts have occurred concurrently with rising tensions in other regions, not least between the US and China and the enduring risk over Taiwan.

This geopolitical fragility has in part been driven by countries becoming more insular, an outcome of passing peak globalisation, rising trade conflicts and, as a consequence of the COVID-19 crisis, the desire to reshore supply chains.

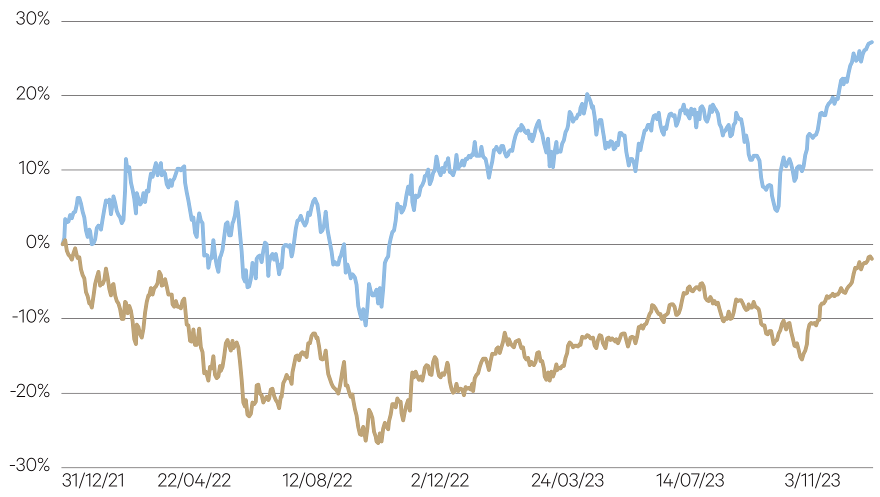
Globally, military spending as a percentage of GDP has declined steadily since the early 1980s and notably since the end of the Cold War in 1991. Military spending was close to 4% at this time, though in the last decade this level has fallen closer to 2%.[1] This gave rise to the notion of a 'peace dividend' that was realised across the world – the belief that lower government spending on defence freed up resources to be spent on domestic policies, such as health care, education or housing.

237,000

Global fatalities from organised violence in 2022, making it the deadliest year since 1994.

Uppasala Conflict Data Program

Amid a rise in geopolitical risk and the emergence of significant conflicts, defence stocks have outperformed the broader market by almost 30% in the last two years.



MSCI World Aerospace & Defence Index · MSCI World
Source: Bloomberg

55

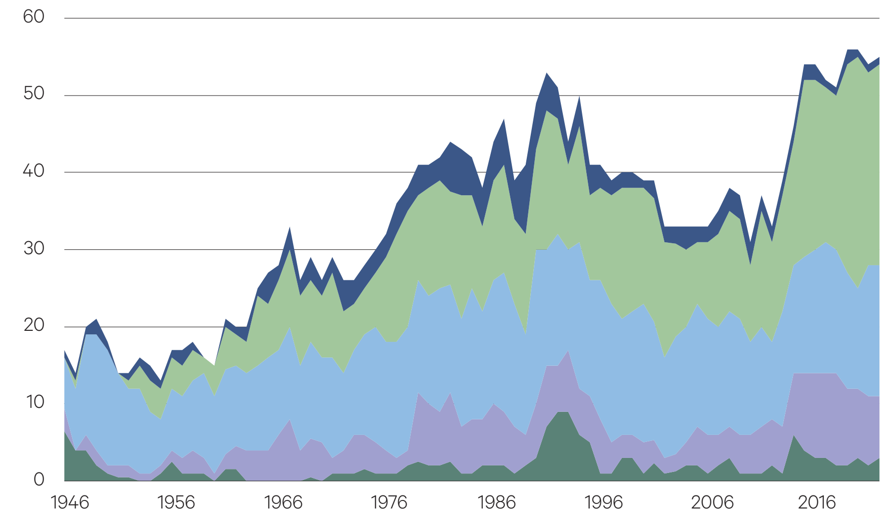
The number of armed conflicts currently.

Journal of Peace Research

[1] https://www.imf.org/external/pubs/ft/fandd/2021/06/military-spending-in-the-post-pandemic-era-clements-gupta-khamidova.htm

That prior trend, however, is now under threat. With greater geopolitical uncertainty, it stands to reason that defence spending around the world will rise and become the 'new normal'. The conflict in Ukraine was a key catalyst, particularly among European countries, to increase budgets. A majority of European NATO members had fallen short of the alliance's 2% of GDP defence spending target for many years, however the last two years has seen increased commitments from several countries, including Germany, the UK, France and Poland. Other countries around the world, such as Japan, have followed suit.

Armed conflicts by region (number)



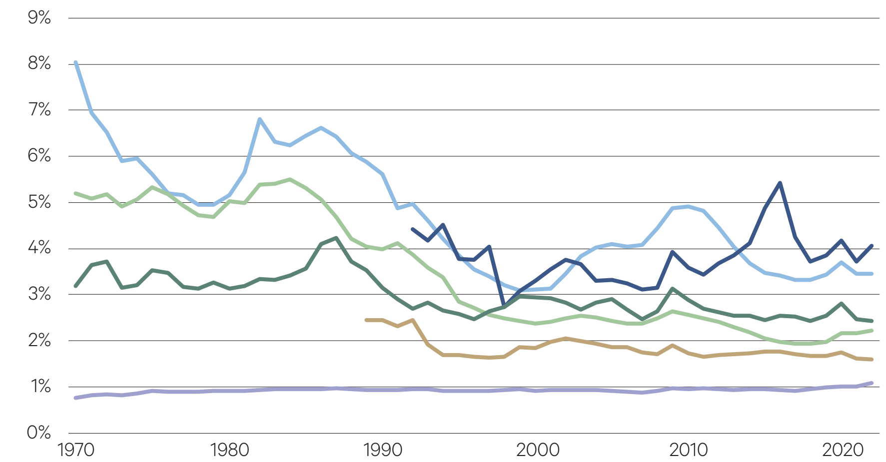
Europe · Middle East · Asia · Africa · Americas
Source: Davies, Shawn, Therese Pettersson & Magnus Öberg (2023); Organized violence 1989-2022 and the return of conflicts between states? Journal of Peace Research

US$874bn

The US defence budget – more than double what it was in 2003 at the time of the war in Iraq.

NDAA FY24

Defence spending (% of GDP)



US · UK · China · Russia · Japan · India
Source: Stockholm International Peace Research Institute

The obvious question to arise from these developments is: how will governments pay for this? The options are new taxes or an increase in debt. While the recovery from the Global Financial Crisis ushered in a period of fiscal policy austerity, the post-COVID-19 era is one marked by fiscal policy recklessness; higher government debt levels would thus be the most probable path taken. Making this more problematic is that ultra-low interest rates can no longer be relied on to finance government spending – wars have become more costly for all.

Geopolitical events can rarely be forecast with an adequate degree of accuracy and hence attempts to protect portfolios from drawdowns are often futile. Indeed, these events typically do not have a lasting impact on markets.

There is, however, a myriad of impacts in which investors should consider. Higher debt issuance mean higher interest rates are necessary for investors to lend money to governments. Higher risk-free rates, of course, lift the required rate of return across all asset classes. Additionally, with greater uncertainty comes greater volatility across a multitude of financial indicators, from currencies to interest rates to commodities to equities.

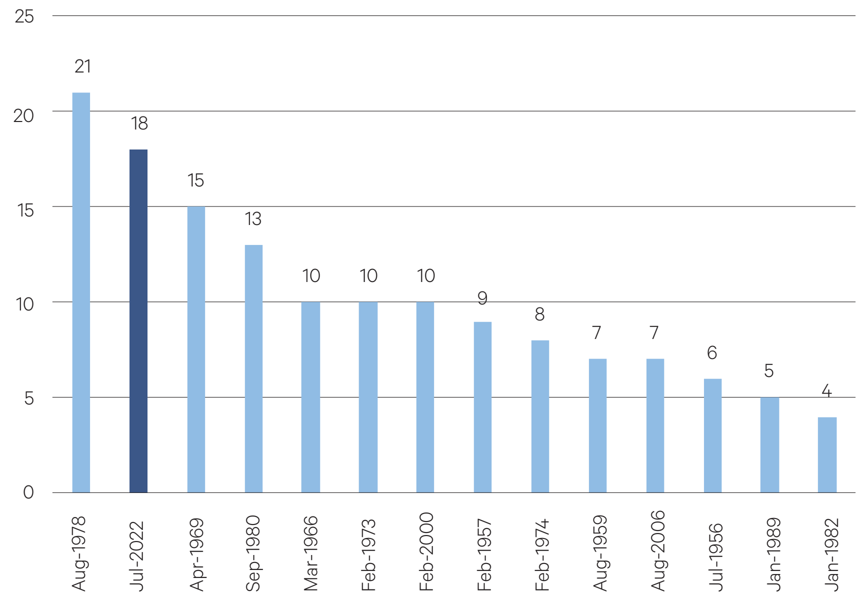
Fixed Income

Tracey McNaughton
Chief Investment Officer

Over the past 21 months, the US has raised interest rates by five-and-a-quarter percentage points, taking the difference between short-term and longer-term interest rates to a level not seen since the 1980s. Known as an inversion, such a situation has historically spelled trouble for an economy – often foreshadowing a recession. Except for an extremely brief/mild inversion in 1998, inversions over the past six decades have had a perfect track record of signaling recessions to come. This is based on the perception that the central bank has taken policy too far into restrictive territory.

The need to raise interest rates so much reflected the fact that the U.S. economy was stubbornly immune to this tightening campaign. There are several possible reasons for this, including pent-up demand for services, strong wage growth and surplus savings. A staggered adjustment process in various interest-sensitive sectors may also have acted as a cushion that lowered the economy's overall sensitivity to higher interest rates.

Duration of yield curve inversion (# of months)



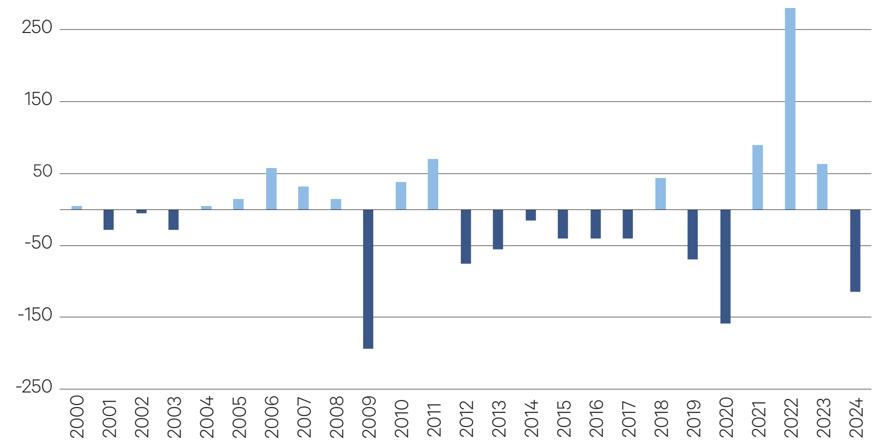
Source: Deutsche Bank

525 bpts

The amount that interest rates were lifted in the last 21 months in the US.

Bloomberg

Global central bank rate hikes vs cuts (annual)



Source: Bank of America

152

The number of rate cuts expected from global central banks in 2024.

Bank of America

None of this is to say there has been a structural change in the way the economy responds to higher interest rates. It was more a reflection of the time.

It is possible then that the Federal Reserve will need to act as aggressively on the downside as these one-off factors wash out of the system. This is certainly what the bond market is pricing in – an aggressive rate cutting program beginning as early as March. Pent-up demand does seem to have been satiated, surplus savings have been spent and wage growth is now falling.

Interest rate cuts will be a theme across most markets in 2024. For the first time since 2020 we are likely to see more global rate cuts than hikes.

The tightening cycle was less aggressive in Australia than in the US. This in part reflects the more interest rate sensitive nature of the Australian economy. While there was pent-up demand for services and sizeable surplus savings, wages growth didn't hit the record highs it did in the US, despite a similarly tight labour market. The rate cutting cycle will start later in Australia than in the US.

425 bpts

The amount that interest rates were lifted in the last 19 months in Australia.

Bloomberg

US$1trn

The annual interest bill on the US$32trn US government debt load.

Bloomberg

Long-maturity bond yields tend to peak around the last rate hike before declining 100 basis points on average over the next year or so. This potential for capital appreciation in the price of the bond, together with the attractive starting yield, makes long-term bonds an attractive choice in 2024. We particularly prefer domestic bonds over global given the higher probability we assign to a recession in Australia.

After the curve inverts, corporate credit spreads tend to peak on average two years later. That means, if past relationships persist, we should expect to see some widening in corporate credit spreads in 2024. This, together with some rise in defaults as growth slows, makes us more cautious on corporate credit this year compared to 2023.

Credit still remains attractive from a yield perspective, however. A yield of between 8-9% for sub-investment grade provides an attractive cushion, even if spreads widen slightly. We believe that income opportunities from higher yields will generate the bulk of fixed income returns in 2024. In that context, we believe investors can meet their fixed income investment objective without taking undue credit risk.

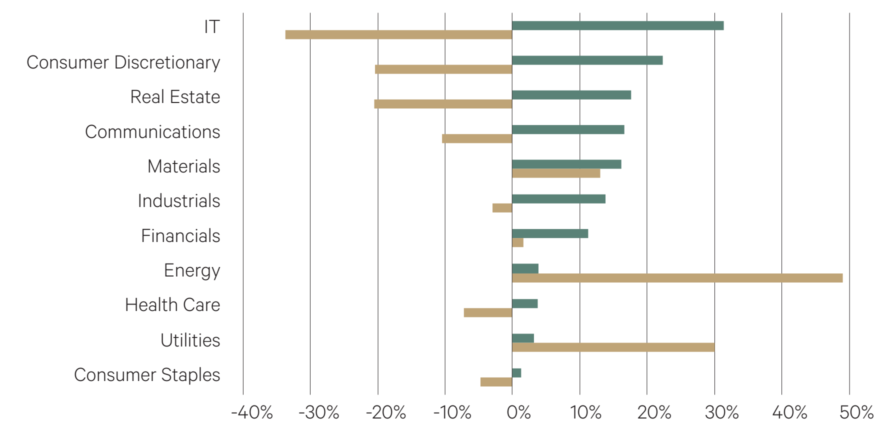
Australian Equities

David Bruty
Investment Analyst

After rallying into the end of the calendar year in sync with global equity markets, the ASX 200 managed to deliver a double-digit total return for 2023.

This outcome was commendable in an environment that presented numerous challenges, including tighter monetary policy, geopolitical risks, persistent inflation and an underwhelming China recovery.

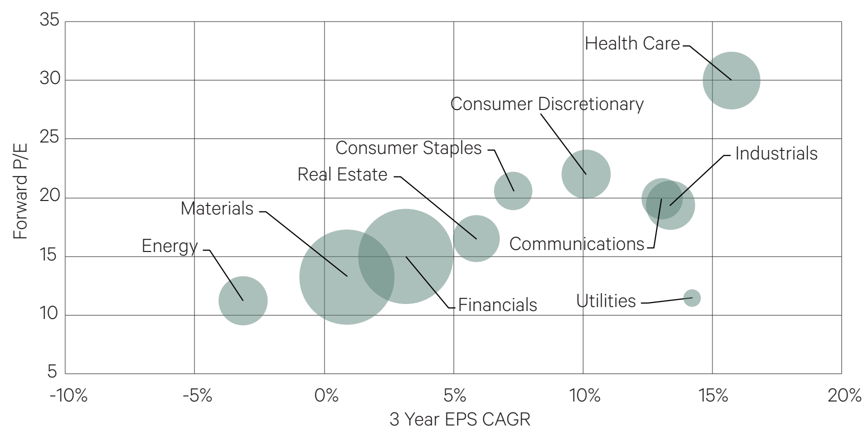
ASX 200: Sector total returns



2023 2022
Source: IRESS

While the Australian market generated a positive return for the year, returns lagged other developed markets, particularly the US and Japan. In a relative sense, Australia was on the wrong side of the key global themes that emerged, particularly artificial intelligence (AI), while the growth in GLP1 drugs (for weight loss) also had a detrimental effect on our domestic healthcare sector.

ASX 200: Sector forward P/E and earnings growth



Source: Bloomberg

31%

Return from IT making it the best performing sector in 2023.

IRESS

The last 12 months was characterised by a period of contraction in forward earnings estimates coupled with valuation (as measured by the P/E ratio) expansion. The latter occurred despite, until late in the year, upward pressure on bond yields. Yields have since fallen precipitously as investors look towards the end of monetary policy tightening and towards an eventual easing.

However, for Australia at least, it may be premature to expect monetary policy relief in the short term. Australia has been a laggard to the rest of the world in bringing inflation under control. The timing and magnitude of any rate cuts here will thus likely also lag other markets, adding a hurdle to domestic market outperformance.

This provides a difficult outlook for industrial stocks that are driven by domestic demand with below-trend GDP growth expected in 2024. There is also a question over earnings forecasts should inflation not decline as anticipated. Demand has so far been resilient due to factors including strong immigration, surplus savings and mortgages that were fixed at much lower rates. However, savings are now being depleted, consumer confidence remains low and household budgets are being squeezed by inflation.

Australia's two large sectors – resources and financials – have modest expectations for the year ahead.

450,000

The number of low fixed-rate home loans that will expire in 2024.

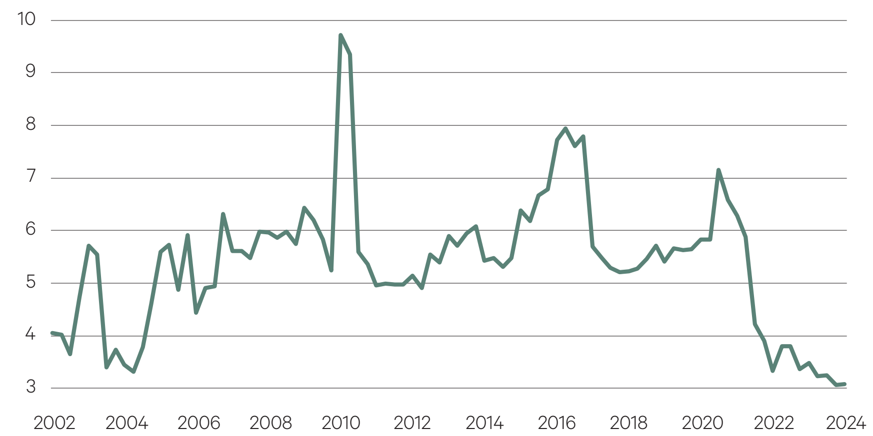
RBA

25%

The extent of the underperformance of ASX small caps to large caps over the last two years.

IRESS

ASX 200: Net debt / EBITDA multiple



Source: Bloomberg

For resources, commodity prices are elevated though are below the highs of the last two years and are unlikely to see significant demand support in 2024. Iron ore has surprised to the upside, though other commodities, such as oil, are well below cyclical peaks. The nascent lithium industry may have a long-term secular growth tailwind from the green energy transition, however spot prices have dived recently leading to considerable share price volatility, imperilling a number of corporate transactions.

The financials sector has been a beneficiary of the rise in interest rates in the last two years, particularly the insurers and banks. In a slowing credit growth environment, however, banks' margins appear to have peaked and now are being pressured by competition.

On a positive note, Australian corporates are well capitalised, the labour market has been resilient and profit margins have held up well. Additionally, income tax relief is scheduled from July, though the economic gain will be muted by the majority of the benefits accruing to higher-income households who have a lower marginal propensity to spend.

With the Australian market trading on a slightly above-average P/E, a reduced risk premium above bond yields, a below-average dividend yield of 4.0% and downside risks to earnings, we have a cautious outlook for the year ahead.

International Equities

Tracey McNaughton
Chief Investment Officer

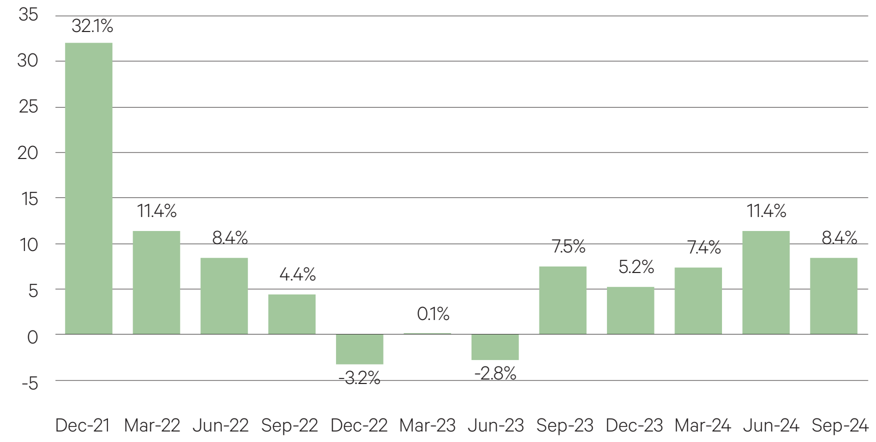
2023 was all about the “Magnificent 7” (Mag7) group of mega cap stocks; Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla. With a weight in the S&P500 index of 29% (a level of concentration not seen since the 1970s), they accounted for two-thirds of the S&P 500’s total annual return.

Can the Mag7 remain Mag?

As we said in our introduction, anything is possible. These stocks, however, are not immune to the business cycle. Lest we forget the halving of the Nvidia share price in 2022.

Long-term, active investors need to look beyond these seven stocks. A soft-landing scenario should see international equities perform reasonably well – particularly in the absence of any exogenous or black swan event.

S&P500 earnings growth



Source: Reuters

10%

The share of humanity that will be 65 or older in 2024.

United Nations World Population Prospects

Some caution is warranted, however. Higher bond yields start to bring corporate debt levels into focus. This is especially important for those companies that either didn’t term out their debt when rates were low or have debt coming due in the next year. Historically, there is about an 18-month lag between a move in bond yields and companies’ effective interest rates.

Higher rates are also important for market valuations, like price/earnings (P/E) ratios. This is the price investors are willing to pay for a dollar of earnings – it is the inverse of the earnings yield (E/P). Periods of higher inflation and interest rates tend to coincide with lower P/Es, or higher earnings yields. This makes sense since the earnings yield for equities is the sum of the cash yield plus a premium for taking equity risk.

The current PE for the US equity market is around 25, implying a 4% earnings yield. With a 5% cash yield currently, the market is implying a negative premium for taking equity risk. No wonder money market funds continue to attract investment flows! For equity prices to move higher from here, a positive premium for taking equity risk needs to be built in. This means a lower PE (higher earnings yield) – achieved either through lower equity prices or higher earnings.

The yield from cash now exceed that of equities (S&P500 earnings yield less the 3 month Treasury bill rate (%))

Source: Bloomberg, data as at 31/12/23

Overall, the equity market can still produce a positive return this year but the heavy lifting will need to come from earnings. That outcome could be met if the consensus is correct in expecting double-digit earnings growth – a significant improvement relative to 2023. Some skepticism is warranted here in a slowing nominal growth environment.

We expect the market will oscillate between expecting a recession and expecting a soft landing. This will create volatility just as it did in 2023 when bond yields moved in a wide range.

More specifically, 2024 will be less about AI’s “creators” and more about its “adopters” – across the spectrum of industries and sectors – as companies increasingly focus their capital spending on productivity-enhancing investments. Health care innovation is another area that could also offer opportunities, as could the energy sector, thanks to capital investment in both traditional and renewable energy sources.

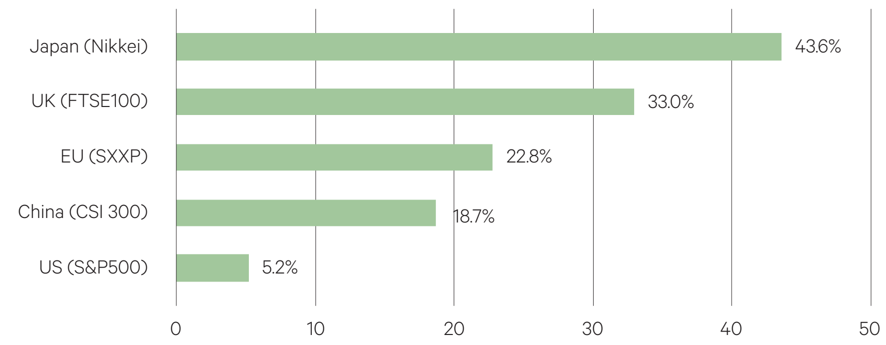
Overall, U.S. equities are likely to have better outcomes than European equities. Japanese equities are also expected to do well. Our focus for emerging markets is outside of China where we see opportunities in markets like India.

US$100trn

The size of the world economy in 2022.

IMF

UK and Japan have the cheapest equity markets (% cos trading below book value)



Source: Bloomberg

80%

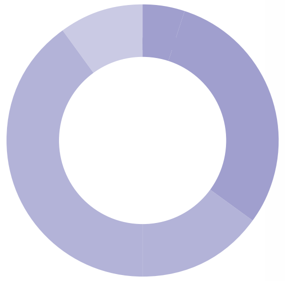
The percentage of firms that plan to increase their investment in AI by over 50% in 2024.

KPMG

Alternatives

Darragh Kennelly
Investment Analyst

Stephen Dickinson
Investment Analyst



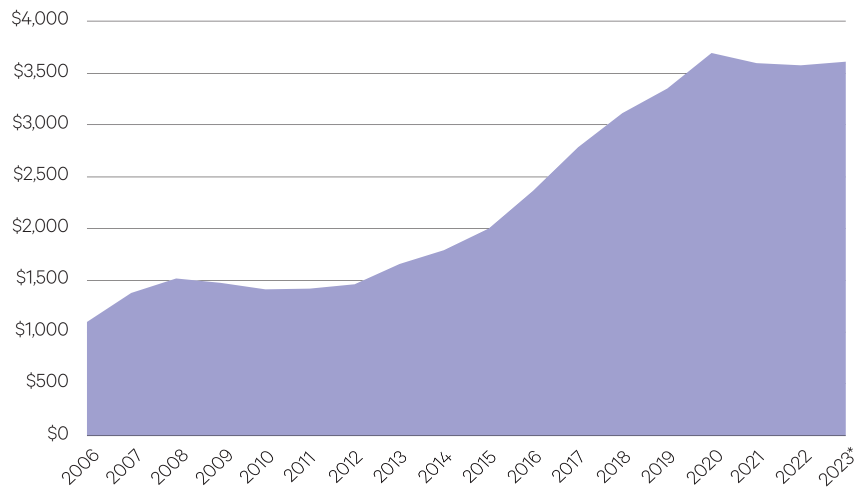
Alternative assets saw continued growth in 2023, especially in areas such as private credit, private equity and infrastructure. The number of public to private transactions increased by 21% in 2023. The year ahead will see increased demand for uncorrelated strategies as the higher rate environment will lead to a more challenging growth environment.

21%

The annual increase in public companies choosing to go private.

S&P Global

Private markets dry powder levels (US$bn)



Source: Pitchbook

US$2.3trn

Expected size of the private credit market by 2027.

Prequin

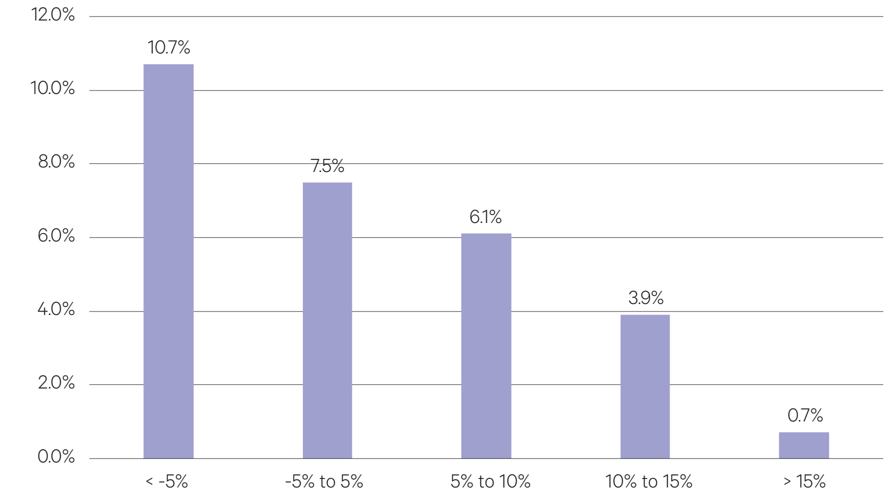
Private credit

Allocations to private credit increased significantly in 2023, with higher base rates and spreads remaining stable. Yields were at their highest in many years for investors. Whilst the higher rate environment will be accompanied by a pickup in defaults, many active managers have used this time to increase the quality in their portfolios, lowering leverage ratios and increasing interest coverage. Total assets in private credit markets are forecast to grow to US$2.3 trillion by 2027 as direct lending and syndicated loans become a more attractive funding source for companies, benefiting from low bank underwriting levels. Stresses will appear in some parts of the economy and opportunistic managers will look to selectively deploy capital here.

Private equity

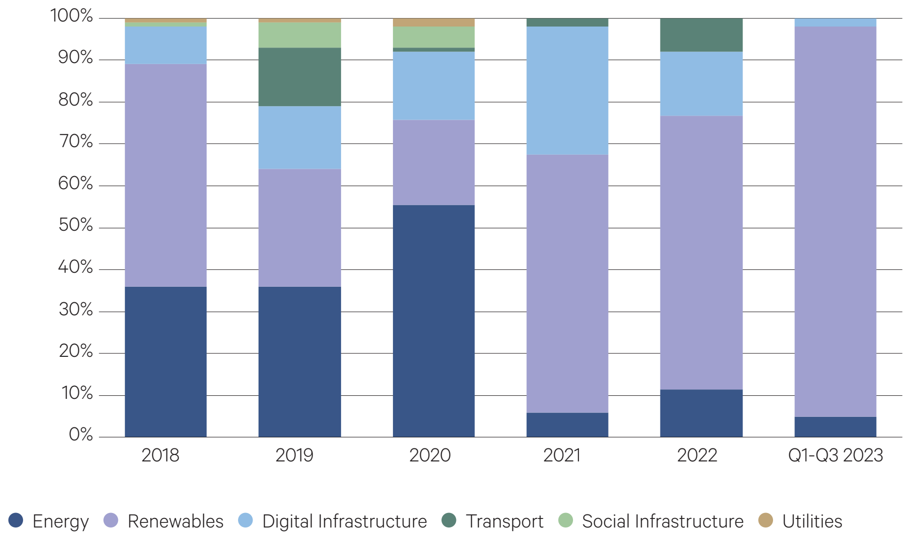
The macro driven uncertainty which caused private equity (PE) dealmaking to hit the brakes in 2023 should unwind as the outlook for further rate hikes is subdued heading into 2024. Ample amounts of dry powder on the sidelines will help transaction volumes, while valuation multiples remain attractive for deploying new capital in areas such as technology, healthcare and industrials. Managers will focus on operational efficiencies and potential add-on acquisitions for market leaders in fragmented industries. Secondaries and continuation funds will come into focus as PE managers look for liquidity solutions for investors.

Excess total return of private equity relative to S&P500 in different market return regimes



Source: KKR, Cambridge Associates, Pitchbook

Infrastructure sector – specific fundraising



Source: Infrastructure Investor, 2023

US$3trn

The global infrastructure gap.

McKinsey Global Institute

Infrastructure

Private infrastructure continues to be underpinned by long-term structural trends including decarbonisation, digitalisation and deglobalisation. Whilst fundraising has slowed, the demand for infrastructure remains helped by regulatory and government support. This is evident in the Inflation Reduction Act in the US and the European Green Deal initiative. Significant opportunities continue to open for investment into next generation infrastructure such as renewable energy and key areas of digitisation like fibre networks, towers and data centres. Long-term drivers such as decarbonisation and the energy transition will offer attractive investment opportunities for investors, while supporting the transition to a net zero emissions world.

Hedge funds

Historically, hedge fund returns have been higher during periods of higher interest rates. Given some of the recent dispersion witnessed between sectors and stocks, the overall environment for active fundamental stock pickers and hedge funds in general remains attractive.

Royalties

As the range of private market strategies continue to expand, the royalty finance sector offers an opportunity to diversify portfolio risk. Royalties have low correlation to traditional asset classes, like stocks, bonds or currencies.

Royalties are long dated streams of cashflow with an average minimum of 10 years of duration and up to 70+ years in certain sectors such as the music royalty space.

Asset Class Quilt of Market Returns

For the first time since 2020, every asset class that we monitor finished the year with a positive return.

Thanks to the performance of the mega cap tech stocks, US equities was the best performing asset class in 2023. International equities also performed well helped by strong gains in Europe and Japan. Emerging market equities underperformed on a relative basis due to a double digit decline in Chinese equities.

High

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
AE 27.6%	EM Eq 30.3%	EM Eq 29.2%	EM Eq 36.5%	AFI 14.9%	EM Eq 74.5%	Gold 29.6%	AFI 11.4%	HY 19.6%	US Eq 29.6%
EM Eq 22.4%	AE 21.1%	AE 25.0%	Gold 30.9%	IFI 9.2%	HY 59.4%	EM Eq 16.4%	IFI 10.5%	AE 18.8%	IE 24.1%
HY 13.2%	Gold 17.9%	Gold 23.2%	AE 18.0%	Cash 7.6%	AE 39.6%	HY 14.8%	Gold 10.1%	EM Eq 15.1%	AE 19.7%
IE 12.8%	IE 7.6%	IE 18.0%	IE 7.1%	Gold 5.8%	IE 27.0%	US Eq 12.8%	Cash 5.0%	US Eq 13.4%	HY 7.3%
IG 9.5%	IFI 6.6%	HY 13.7%	Cash 6.7%	IG -8.6%	Gold 24.4%	IE 9.6%	IG 4.3%	IE 13.2%	Cash 2.9%
US Eq 9.0%	AFI 5.8%	US Eq 13.6%	IG 6.7%	HY -26.9%	US Eq 23.5	IFI 9.3%	HY 3.1%	IG 11.2%	IFI 2.3%
IFI 8.9%	Cash 5.7%	IG 7.2%	IFI 6.6%	US Eq -38.5%	IG 19.2%	AFI 6.0%	US Eq 0.0%	IFI 9.7%	AFI 2.0%
AFI 7.0%	HY 3.6%	Cash 6.0%	AFI 3.5%	AE -40.4%	IFI 8.0%	IG 5.8%	IE -7.6%	AFI 7.7%	IG 0.3%
Cash 5.6%	UE Eq 3.0%	IFI 4.4%	US Eq 3.5%	IE -42.1%	Cash 3.5%	Cash 4.7%	AE -11.4%	Gold 7.1%	EM Eq -5.0%
Gold 5.5%	IG -3.6%	AFI 3.1%	HY 3.2%	EM Eq -54.5%	AFI 1.7%	AE 3.3%	EM Eq -20.4%	Cash 4.0%	Gold -28.3%

Low

AE: Australian Equities
HY: High Yield Credit
Gold
IFI: International Fixed Income
EM Eq: Emerging Market Equities
Cash
AFI: Australian Fixed Income
US Eq: US Equities
IG: Investment Grade Credit
IE: International Equities

Source: Bloomberg, 2023 data as at 31/12/2023

High yield credit bounced back strongly after recording its worst return (since the 2008 global financial crisis) in 2022. The attractive high starting yield for high yield makes it an attractive asset class still for 2024.

After two ordinary years, gold made a comeback in 2023. Geopolitical tensions ignited by the conflict in the Middle East, coupled with a continuing decline in inflation and the prospect of interest rate cuts in the United States, have propelled the rise in gold to a new all-time high.

Cash moved from being the best performing asset class in 2022 to being the worst in 2023 – albeit with a positive return. Indeed, thanks to the five rate hikes from the Reserve Bank, leaving interest rates at their highest level since December 2011, cash finished the year with its highest annual return since 2012.

An important observation to make from the asset class quilt is the importance of diversification. Every asset class, at some point, has been among the best performers, even cash.

2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
US Eq 11.4%	AE 3.8%	HY 14.3%	EM Eq 34.3%	AFI 4.5%	US Eq 28.9%	Gold 25.1%	US Eq 26.9%	Cash 1.3%	US Eq 24.2%
IFI 10.4%	IFI 3.3%	AE 11.6%	IE 20.1%	Cash 1.9%	IE 25.2%	US Eq 16.3%	IE 20.1%	Gold -0.3%	IE 21.8%
AFI 9.8%	AFI 2.6%	US Eq 9.5%	US Eq 19.4%	IFI 1.6%	AE 24.1%	EM Eq 15.8%	AE 17.7%	AE -3%	HY 14.0%
AE 5.0%	Cash 2.3%	EM Eq 8.6%	Gold 13.5%	Gold -1.6%	Gold 18.3%	IE 14.1%	HY 0.9%	AFI -9.7%	Gold 13.1%
IG 3.1%	US Eq -0.7%	Gold 8.1%	AE 12.5%	AE -3.5%	EM Eq 15.4%	IG 10.4%	Cash 0.0%	IFI -12.3%	AE 13.0%
IE 2.9%	IE -2.7%	IE 5.3%	HY 10.4%	IG -3.6%	HY 12.6%	HY 7.0%	IFI -1.6%	HY -12.7%	IG 9.6%
Cash 2.7%	HY -2.7%	IFI 5.2%	IG 9.1%	HY -4.1%	IG 11.5%	IFI 5.1%	AFI -2.9%	IG -16.7%	EM eq 7.0%
HY 0.0%	IG -3.6%	IG 4.3%	AFI 3.7%	US Eq -6.2%	AFI 7.3%	AFI 4.5%	IG -3.2%	US Eq -19.4%	IFI 5.3%
Gold -1.4%	Gold -10.4%	AFI 2.9%	IFI 3.7%	IE -10.4%	IFI 7.2%	AE 3.6%	Gold -3.6%	IE -19.5%	AFI 5.1%
EM Eq -4.6%	EM Eq -17.0%	Cash 2.1%	Cash 1.7%	EM Eq -16.6%	Cash 1.5%	Cash 0.4%	EM Eq -4.6%	EM eq -22.4%	Cash 3.9%

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