PRINCIPIA

INVESTMENT CONSULTANTS

QUARTERLY MARKET REPORT

DECEMBER 31, 2023

Pivot Party

At the start of this year every market commentator and analyst seemed to be planning for the recession they were convinced was coming. Equities and bond yields would all tumble as the fastest interest rate increases in a generation would plunge the world into a recession.

But something else was going on. Artificial-intelligence shares were red hot and were taking the chip makers with them - the “Magnificent 7” large tech stocks dominated US equity gains. By the end of September world equity markets were up 17% (in AUD) but the global bond market looked like producing its third negative year in a row - the exact opposite of earlier predictions.

But then the last two months of 2023 saw a remarkable shift in sentiment. In October both the RBA and the Federal Reserve kept up the mantra that interest rate would stay “higher for longer”, but in November data showed U.S. and European inflation falling much faster than expected. Suddenly everything, everywhere, all at once changed.

Bond yields started plummeting – but not because of recession. The market now expected that the “terminal rate” for interest rates had been reached, and that the economy would glide into a “soft landing”. Global stocks, listed real estate and corporate bonds all surged higher.

The Fed then triggered fresh market excitement when it used its December meeting to say unequivocally that rate hikes were over. More telling though was the Fed's "dot plot" which envisaged three 25 bp cuts in 2024. The pivot party kicked into euphoric mode.

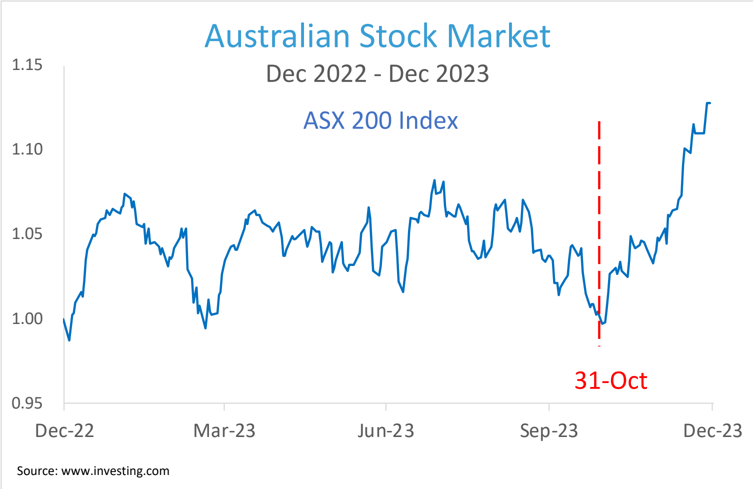
The last quarter of 2023 has ended on a high – but all parties must come to an end. Can global equities keep rallying based on optimism over Fed rate cuts, or will the slowdown in the global economy end up being more severe than currently envisaged? Are we really set for a “soft landing” and is inflation truly vanquished? Could global geopolitical relations deteriorate further?

How will markets respond to those risks? The coming year will provide answers to these questions – and no doubt present new risks and opportunities.

Equity and Bond Market Overview

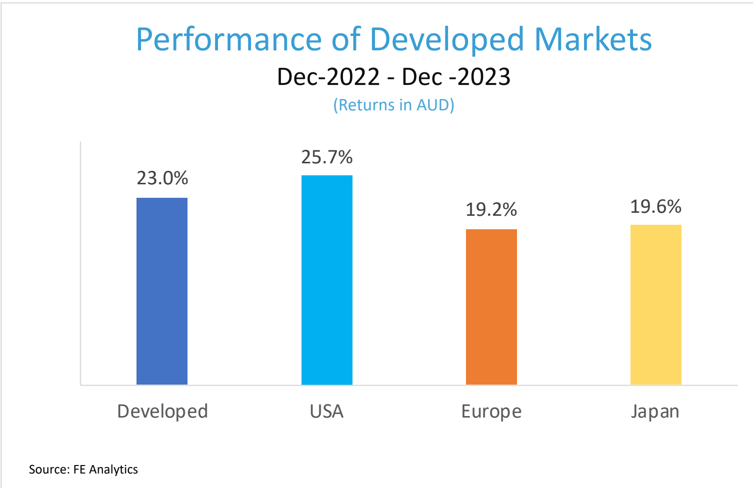
ASX FLYING HIGH IN Q4 AT THE PIVOT PARTY

The ASX spent most of the year in a holding pattern as concerns around where inflation would take interest rates dominated sentiment. By the end of October the market was flat for the year, and the outlook was gloomy. However, with inflation data lower than expected, and the Fed pivot, the ASX added a stunning 12% through November and December.



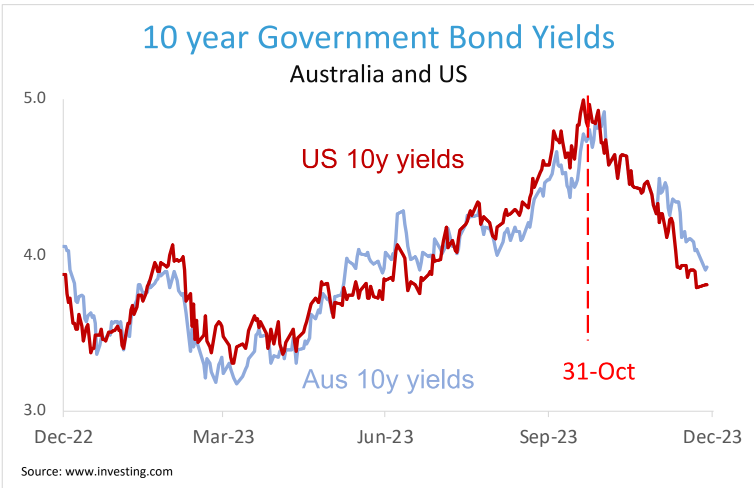
DEVELOPED MARKETS HAVE IGNORED HIGHER RATES

This stock market rally in the first half of 2023 was built on the back of technology stocks. But now with the Fed pivot all sectors are booming, and developed markets are giving some of the best returns in years. The strong performance in international markets continues to reinforce the benefits of globally diversified portfolios.



YIELDS PLUMMET AS MARKET PRICES IN RATES FALL.

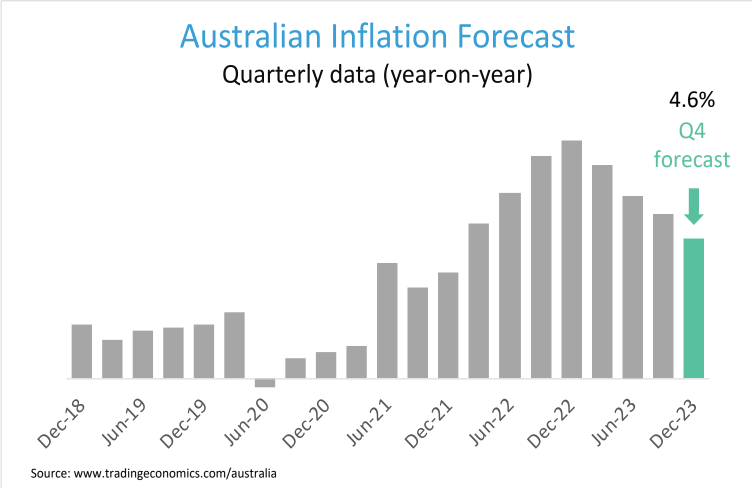
A huge two-month rally in bond prices has rescued fixed income markets from an almost unheard-of third straight year of declines. The U.S. 10-year Treasury yield, the benchmark for borrowing costs globally, has dropped 100 basis points (bps) since November, the biggest fall since 2008.



Economic Review and Forecasts

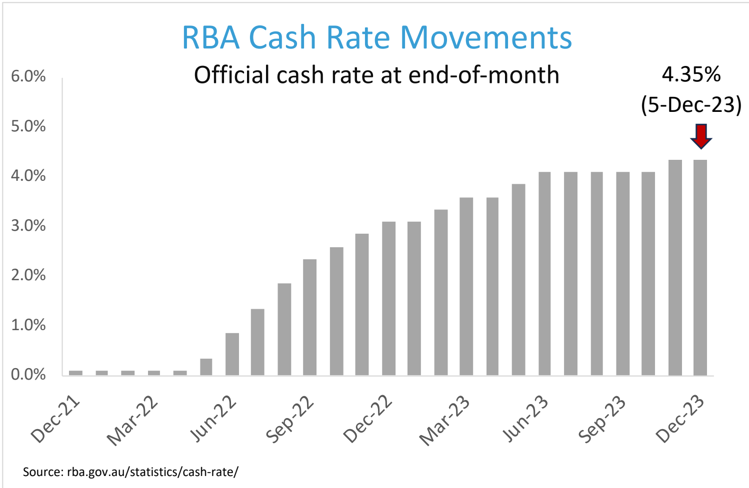
INFLATION CONTINUES TO FALL BUT REMAINS ABOVE TARGET.

When the wave of inflation swept the globe in late 2021, Australia lagged by about six months. Given the rapid fall in inflation in the US then Australia should follow a similar path. However, the RBA will be looking at the data to see if there is a bigger structural issue at play keeping inflation – and interest rates – higher for longer.



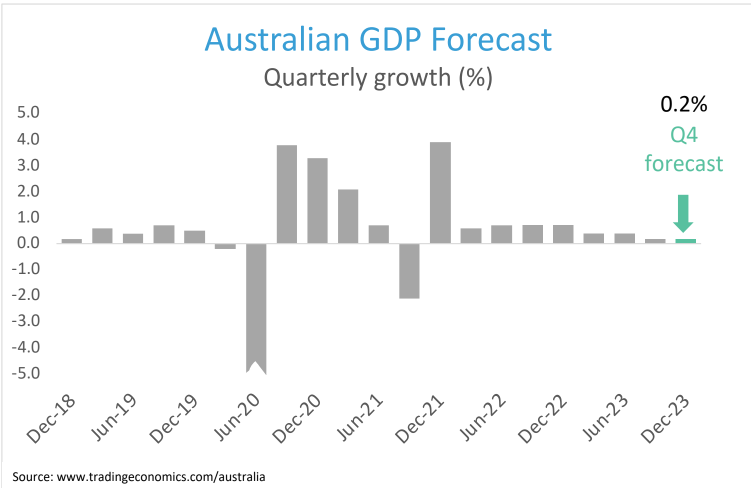
INTEREST RATES MOST LIKELY AT THE TERMINAL RATE

As inflation continues its downward trend, the RBA remains in a wait and see mode. While the RBA left the cash rate on hold at 4.35% at its final board meeting of 2023, the minutes of that meeting reaffirm another interest rate rise may be necessary, although the Fed's pivot has reduced the risk of any further increases.



AUSTRALIA REMAINS ON TRACK FOR A SOFT LANDING.

The economy continued to slow throughout the year, with consensus expectations of GDP growth of 0.2% for Q4 2023. Soaring mortgage repayments, rising cost of living, falling real wages and higher taxes due to bracket creep all coalesced to hammer household budgets and consumption.



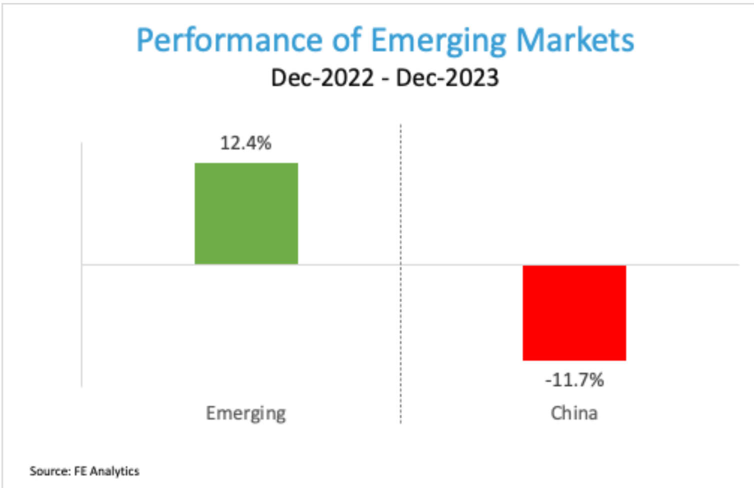
Market Returns

Asset Class	Year to Date	3 Months	1 Year	3 Year	5 Year	10 Year
Cash		1.1%	3.9%	1.7%	1.4%	1.8%
Australian Bonds		3.8%	5.1%	-2.7%	0.6%	2.6%
Global Bonds		5.4%	5.3%	-3.1%	0.5%	2.6%
Australian Equity		8.4%	12.4%	9.2%	10.3%	7.9%
Developed Markets		5.3%	23.2%	11.8%	13.6%	11.7%
Developed Markets (hedged)		9.4%	21.9%	7.4%	11.8%	9.6%
Emerging Markets		2.0%	9.2%	-1.1%	4.3%	5.5%
Australian REITS		16.6%	17.6%	5.7%	6.1%	9.2%
Global REITs		9.2%	9.5%	7.4%	4.8%	7.6%

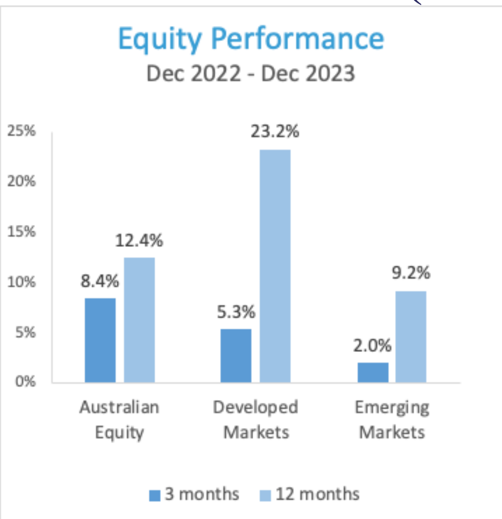
- Global shares and bonds have enjoyed a strong rally in the past two months as traders priced in six rate cuts or more than 150 basis points of easing next year by central banks as inflation continues to slide.
- The US 10-year Treasury yield has fallen by more than 1% in the quarter resulting in the global bond index returning 5.4% in that period, and 5.3% for the year.
- The Australian sharemarket is up 12.4% for the year – its best return since 2021. Most of that performance came from the last quarter, which returned 8.4%
- The MSCI's world index, the broad gauge of global developed market equities, posted a 23.2% gain for the year, and a 5.3% gain for the quarter.
- The Aussie dollar rose sharply against the US dollar in the last quarter on the back of falling 10y Treasury yields. Consequently, the hedged MSCI World index outperformed the unhedged index by 4.1% in the quarter.
- Emerging Markets continue to lag developed markets, principally because of the poor performance of China.
- Australian REITs outperformed the equity market in the quarter and over the year, although it was the reverse when looking at global REITs against global equities.

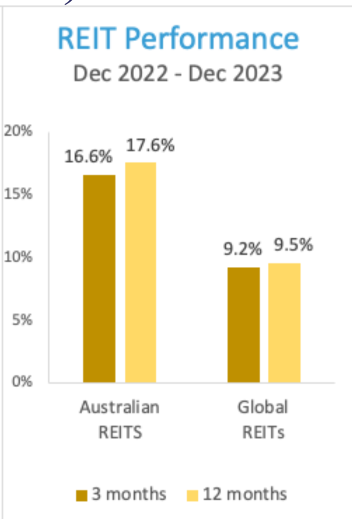
CHINA DRAGS DOWN THE EMERGING MARKETS

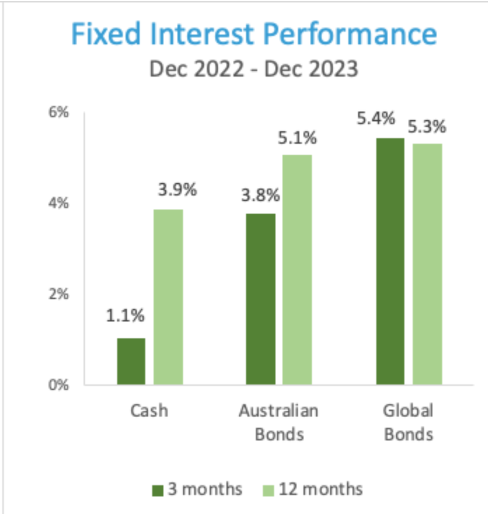
Emerging countries outside of China have had a similarly strong year as the developed markets However, China is around 35% of the EM index, and is facing a host of problems - including slow growth, high youth unemployment and a property sector debt crisis. The MSCI China index is down -11.7% for the year, and -9.4% for the quarter.



Market Returns (Chart)



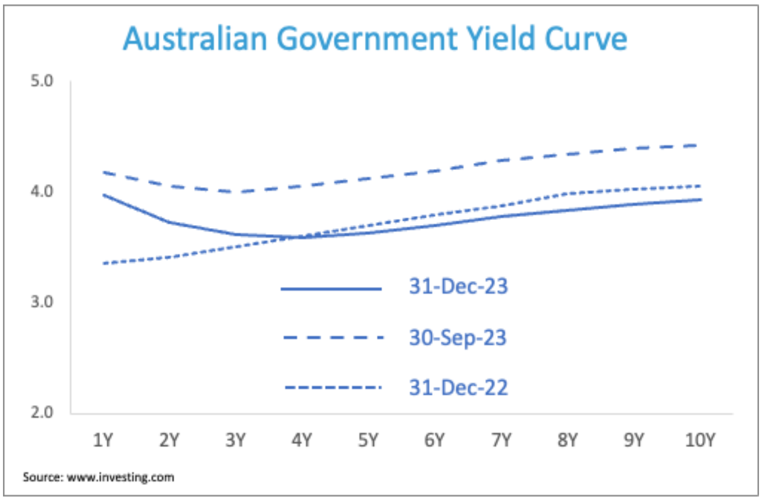




Yield Curves

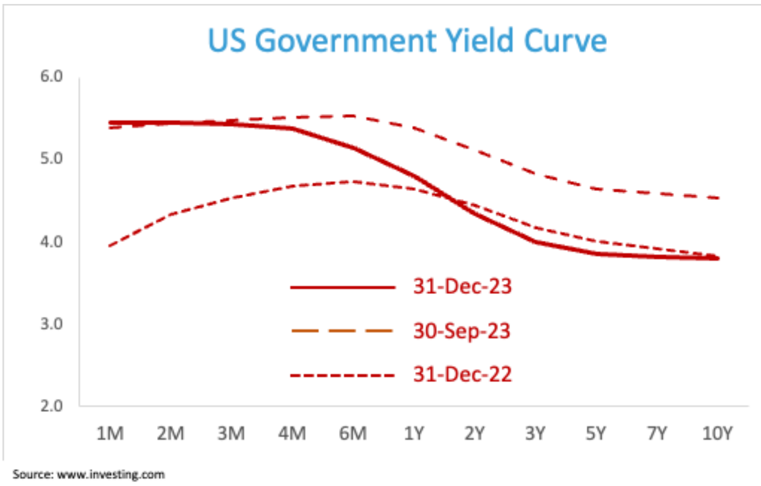
AUSTRALIA

Short end yields came down slightly over the quarter as the market continued to assess inflation data. However, 10-year government bond yields fell below 4%, hitting its lowest levels since the start of the year as the Fed pivot has led bond traders to price out any risk of another rate hike from the Reserve Bank of Australia.



UNITED STATES

The US yield curve remains inverted as the 10-year Treasury yield has fallen by 100 bps in the quarter. At the beginning of December, the Fed pointed to three interest rate cuts in 2024, with additional reductions anticipated in 2025 and 2026 due to the faster than anticipated decrease in inflation. Most economists now favour the soft landing scenario as more likely than a recession.



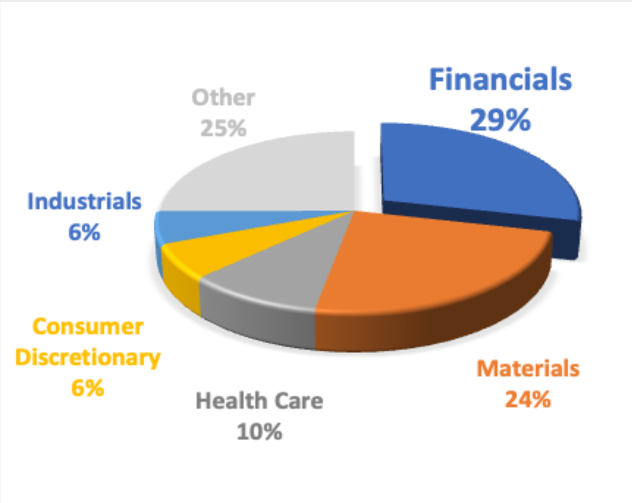
Sector Performance

AUSTRALIA

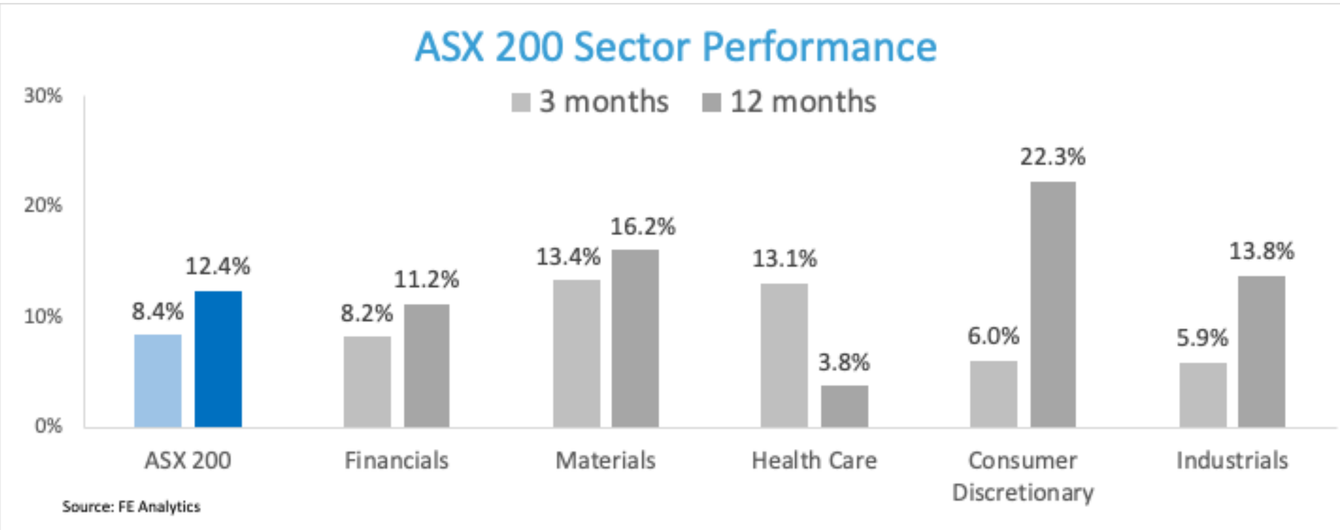
Of the largest sectors in the ASX Consumer Discretionary stocks have performed strongly in the quarter and the over the year, which is counter intuitive to the data that shows consumers are cutting back on spending amid continuing high inflation. The resource sector has benefitted from lower rate expectations, providing a boost to the Materials sector. Energy has been the worst performer as coal, gas and oil are all down for the year.

Sector	3 months	12 months
ASX 200	8.4%	12.4%
Communication Services	6.8%	16.6%
Consumer Discretionary	6.0%	22.3%
Consumer Staple	0.2%	1.3%
Energy	-9.1%	3.8%
Financials	8.2%	11.2%
Health Care	13.1%	3.8%
Industrials	5.9%	13.8%
Information Technology	6.6%	31.3%
Materials	13.4%	16.2%
Real Estate	15.8%	16.1%
Utilities	-2.1%	3.2%

Five sectors make up approximately 75% of the market, with the two largest constituting more than 50%. The bottom chart shows the 12-month performance of the five largest sectors.



Sector	Weight
Financials	28.8%
Materials	25.7%
Health Care	9.1%
Consumer Disc	6.9%
Real Estate	6.7%
Industrials	5.5%
Consumer Staples	4.8%
Communication Services	3.9%
Information Technology	3.6%
Energy	3.8%
Utilities	1.3%



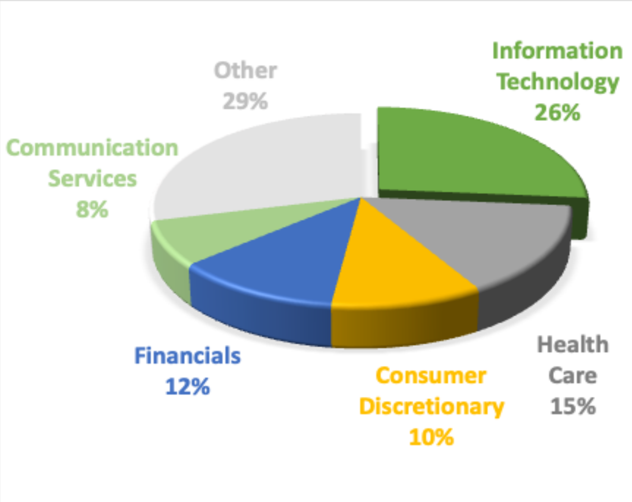
Sector Performance

UNITED STATES

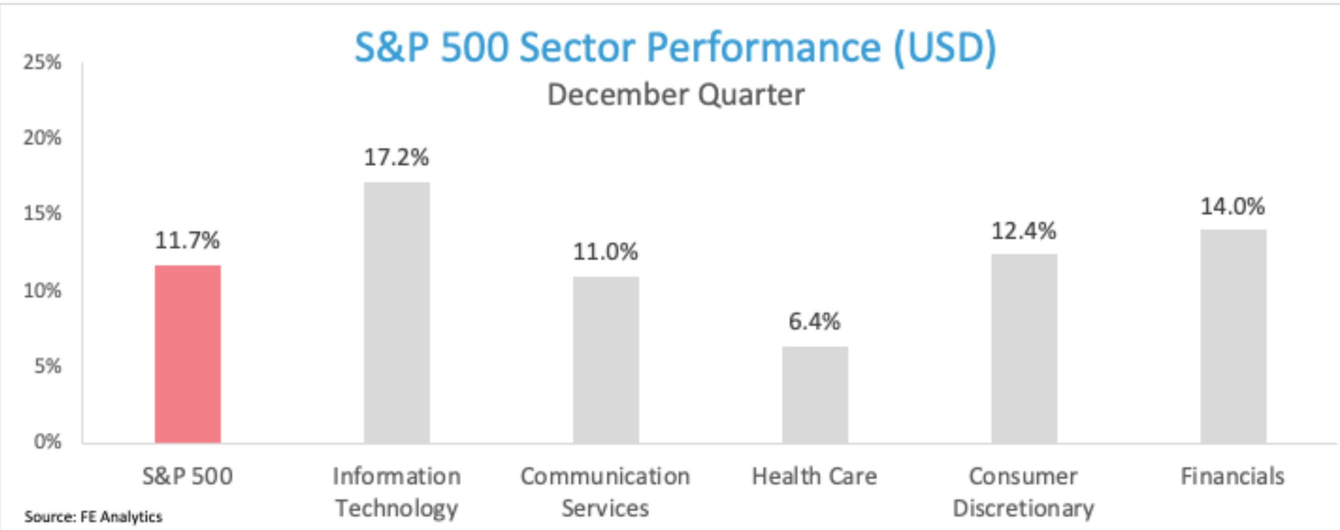
Despite the continuing rate rises throughout most of 2023 the US tech sector (IT and Communications) has had exceptional 12 month returns as the large Nasdaq stocks have benefited from the AI hype. However, their returns have been less stellar in the last quarter as Financials and Real Estate have benefitted from the Fed pivot. As in Australia, Consumer Discretionary has had a strong year, defying the predictions of a recession at the start of the year.

Sector	3 months	12 months
S&P 500	11.7%	26.3%
Communication Services	11.0%	55.8%
Consumer Discretionary	12.4%	42.4%
Consumer Staple	5.5%	0.5%
Energy	-6.9%	-1.3%
Financials	14.0%	12.2%
Health Care	6.4%	2.1%
Industrials	13.1%	18.1%
Information Technology	17.2%	57.8%
Materials	9.7%	12.6%
Real Estate	18.8%	12.4%
Utilities	8.6%	-7.1%

Five sectors make up approximately 75% of the US market, with Tech companies constituting around 40%. The bottom chart shows the 12-month performance of the five largest sectors.



Sector	Weight
Information Technology	28.0%
Health Care	13.6%
Consumer Discretionary	12.0%
Financials	11.1%
Communication Services	9.4%
Industrials	7.9%
Consumer Staples	6.1%
Real Estate	2.8%
Energy	3.9%
Materials	2.6%
Utilities	2.7%



Source: FE Analytics

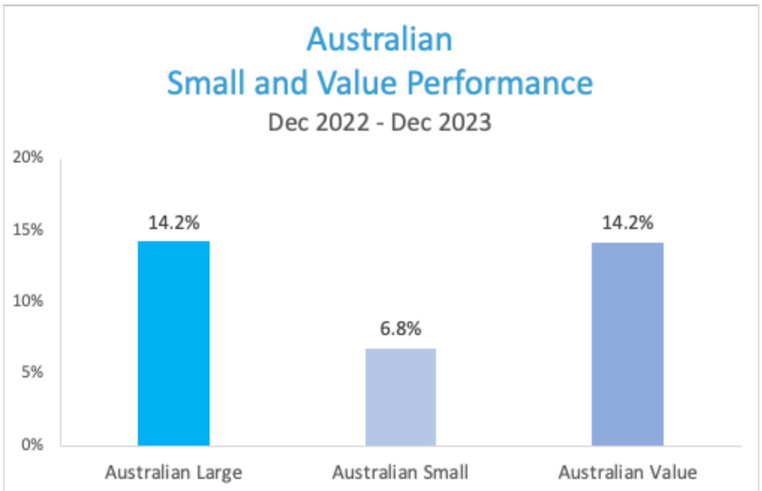
Equity Factors - Small and Value Premiums

Asset Class	YtD	3 Months	1 Year	3 Year	5 Year	10 Year
Australian Large		9.0%	14.2%	10.5%	10.6%	8.1%
Australian Growth		9.0%	14.5%	6.4%	9.1%	8.4%
Australian Small		6.4%	6.8%	4.8%	9.9%	7.9%
Australian Value		9.0%	14.2%	14.2%	11.3%	7.2%
Global Large		5.4%	23.9%	12.3%	14.2%	12.3%
Global Growth		7.2%	37.0%	10.3%	17.2%	14.5%
Global Small		6.5%	16.0%	7.8%	11.0%	10.3%
Global Value		3.5%	11.7%	13.7%	10.4%	9.7%

Source: FE Analytics. See below for MSCI indices used to define Large, Small, Value and Growth

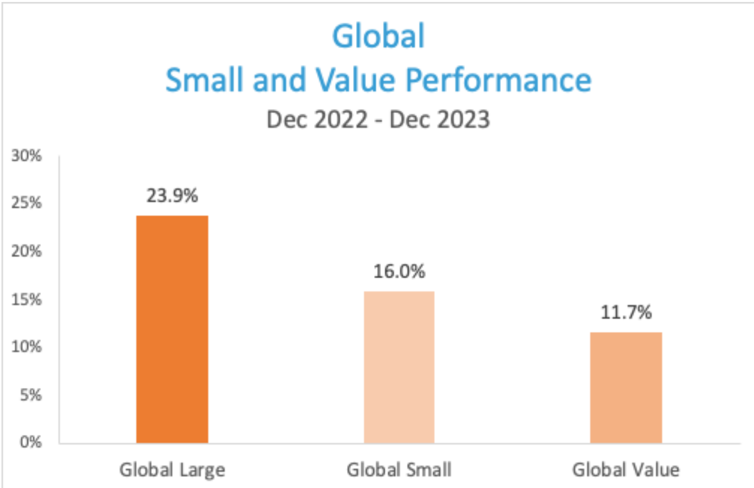
Australian Factors

Factors are very volatile over short time periods. Looking over the course of the last 12 months, there is no significant style premium between value (lower relative price) stocks and growth (higher relative price) stocks. However smaller companies continue to under-perform the broader market.



Global Factors

The global markets are dominated by the US, which accounts for approximately 70% of the MSCI World Index. The biggest driver of US returns in the last year has been the large growth tech stocks, resulting in value and small cap stocks underperforming the broader market. However, the MSCI World ex-USA index has delivered a value premium.



MSCI Australia TR
MSCI Australia Small Cap TR
MSCI Australia Value TR
MSCI Australia Growth TR

MSCI World ex Australia Index (ATR, AUD)
MSCI World ex Australia Small Cap Index (ATR., AUD)
MSCI World ex Australia Value Index (ATR, AUD)
MSCI World ex Australia Growth Index (ATR, AUD)

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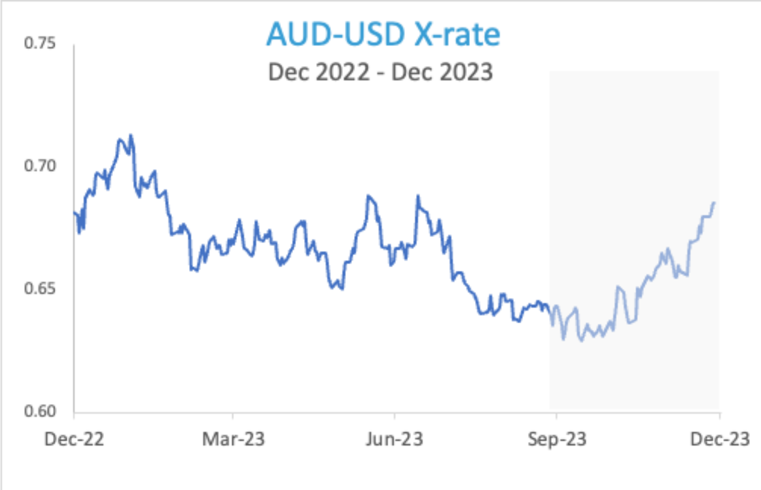
Currency and Commodities

EXCHANGE RATE

The Australian dollar was up nearly 3% in the quarter, as the differential between Australia and US 10 year bond yields narrowed.

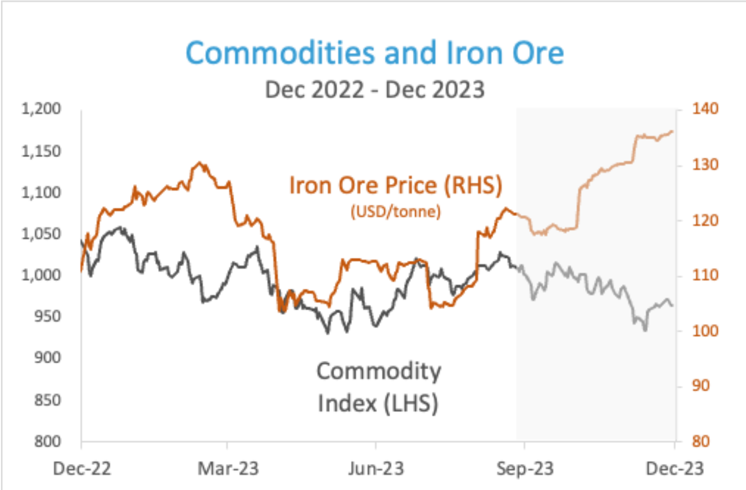
The RBA will likely trail global peers in shifting to an easing cycle as it has not hiked as aggressively as other central banks, probably resulting in shallower or later cuts.



COMMODITIES AND IRON ORE

The Commodity index is down around 4% in the quarter as oil, one of the biggest contributors to the index weighting, is down by more than 20% amid rising crude production and an uncertain demand outlook.

Prices for iron ore will close the year around 23% higher in a period of robust demand for industrial metals, particularly from China.



Source: www.investing.com

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