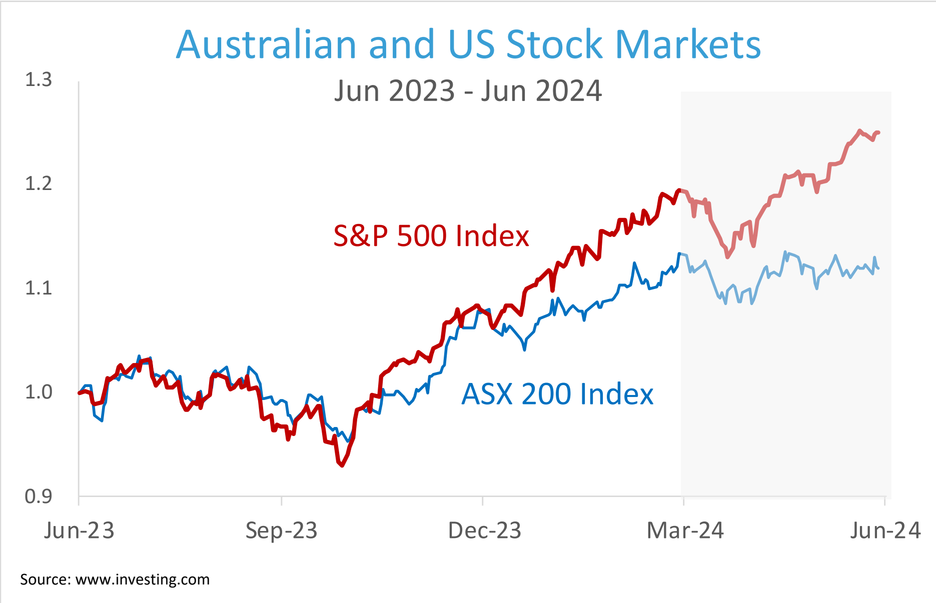
Holding Pattern: Markets are Waiting for Clear Skies

The last financial year has seen excellent returns for investors, with the Australian market returning 12.1% and international markets up 19.9%. But it has not been a smooth journey, and recently markets seem to be in a holding pattern, waiting for economic skies to clear. Around the world, different asset classes have pulled back in the June quarter, apart from a very narrow rally in a handful of tech stocks associated with AI applications.

Looking back over the last financial year, it has been a very good year for stock markets. Developed markets are up near 20%, led by the US and more particularly a handful of tech stocks that are benefiting from the potential of Artificial Intelligence applications. The Australian market has also had a strong 12 months returning just over 12%, which is a little better than the average financial year return over the last 40 years[1].

But as always, when looking over the performance of markets over a 12-month period, the journey to get to the end has not been a smooth one. Back at the start of the financial year in July 2023 the market was experiencing turbulence as the RBA continued to raise rates even as the economy was slowing, and by the end of October the market was down over 5%. But a remarkable rally started late in the year when the RBA – and the Federal Reserve in the US – signaled that interest rate increases were over and the next move – sometime in the future – would be downward.

In what has been termed the “pivot party,” markets around the world rallied, and from early November until the start of this quarter, the ASX was up nearly 20%, and in the US the S&P 500 index was up close to 30%. But a divergence has occurred in this quarter between the Australian and US markets, While AI stocks continue to drive the US – notwithstanding a wobble in the last week – the Australian market has been in a holding pattern for the quarter, returning -1.1%.



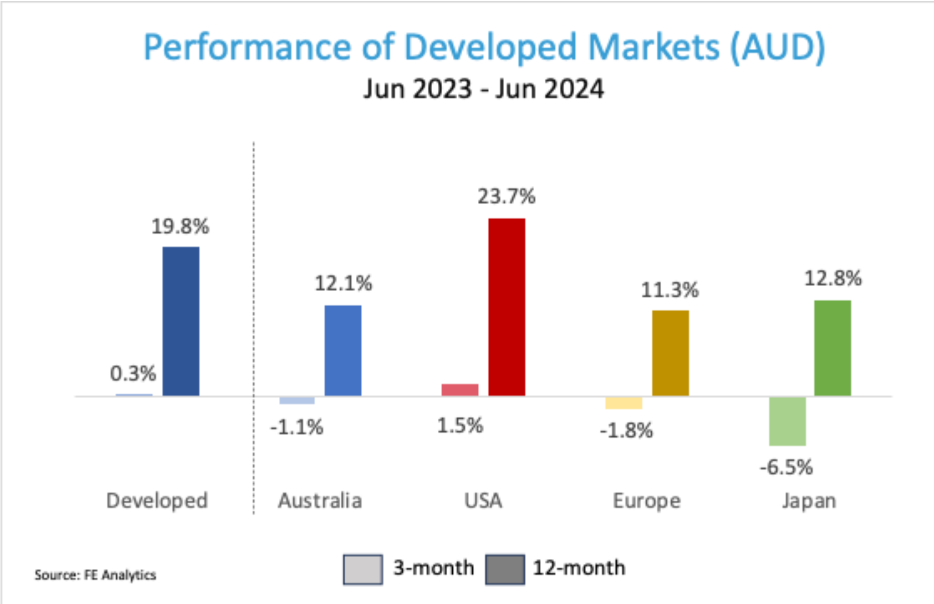
The reason for the divergence in the June quarter – and a major reason for the volatility in markets over the financial year – has a lot to do with the path of inflation in the two countries and the expected course of interest rates. Globally inflation peaked in October 2022 and has been on a downward trend since then - but inflation prints have surprised on the upside at times.

Over the June quarter both the RBA and the Feds kept their respective rates on hold, but the message from the two central banks has been quite different. In the US, inflation continues to fall more in line with expectations, and in their last meeting, the Feds confirmed that they expected a single rate cut for 2024 and foresee four reductions instead of three in 2025.

When the RBA announced they were keeping rates on hold, the message was far more hawkish, and upward revisions to the inflation forecast were greater than anticipated. By the end of June, Australia's inflation had accelerated faster than expected for a third straight month, sending bond yields and the AUD higher as traders upped bets that the RBA will resume raising interest rates at its next meeting.

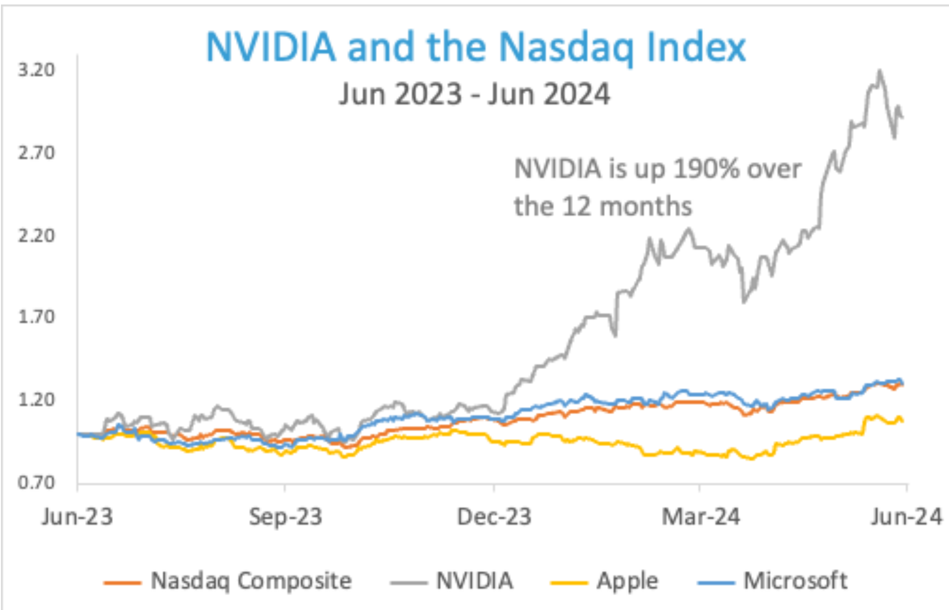
The returns for Australia over the year and the quarter have also been pulled back by the concentrated nature of our market. Financials – which make up 30% of the ASX – are up 29% for the financial year, but only 4.1% in the June quarter. Balancing that is the materials sector – which makes up a further 20% of the ASX – which is slightly negative for the year but down 6% for the quarter. A significant factor in this return is the drop in iron ore prices as demand from China remains weak.

The subdued performance in the quarter is not just in the Australian market, nor is it all due to changing inflation expectations. There has been a broad pull-back in equities across the world in the last quarter. In the chart below we show the 3-month and 12-month performance of Australia and the major developed markets that make up the MSCI World Index. Except for the US – which makes up close to 70% of the MSCI World Index – other markets have seen a retreat from their highs back at the end of March.



Over the long-term, stock markets have presented a reasonable nexus with underlying economic activity, as earnings growth tends to link the two together. While disinflation generally continues (except for Australia) the global GDP growth remains below par. The higher interest rates that were instigated as a response to the post -pandemic inflation spike is still working their way through different economies, and the respective stock markets seem to have pulled back into a holding pattern waiting for the economic sky to clear.

The US market appears to be doing better than its economy suggests, but this is a very narrow rally driven by a handful of stocks involved with AI applications. The top 3 weights in the S&P 500 Index are Microsoft, NVIDIA and Apple, which combined make up around 20% of the index. As the chart below shows, NVIDIA is a major factor in the performance of the US (and the World index more broadly). This outperformance has not been without significant earnings growth, but the question for investors might be when and how much of the benefits of AI will flow into positive economic returns for the broader economy.



Other asset classes have seen similar behavior to the broader equity markets. Australian REITs have returned nearly 25% for the financial year, significantly outperforming the listed equity market and their global REIT peers. However, they have come back in the last quarter and returned negative 5.6% as Australia's sticky inflation threatens a possible interest rate rise.

The other interest rate sensitive asset class is bonds. Yields remain volatile and elevated as bond traders' price in changing expectations around inflation and the subsequent course of interest rates, but nonetheless global bonds (hedged to AUD) have returned a positive 3% for the last 12 months – slowly clawing back the steep price drops of 2022 – but have returned close to 0% in the June quarter. It is important to note that the higher bond yields give comfort that there is plenty of room for yields to come down if there is a flight to safety in the wake of any major equity downturn.

Overall, while the quarter has been one of markets seemingly stuck in a holding pattern waiting for conditions to improve, the financial year returns have been excellent. A diversified portfolio of Australian and international shares and global bonds has returned more than the 30 year average for financial year returns[2].

The best course of action for investors is to ignore the constant news cycle that reports on every inflation print as if it somehow determines the future of their portfolio. Tune out the financial media noise and stay disciplined in a well-diversified portfolio that has been created to meet your needs.

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[1] Since July 1981 the average financial year return for the S&P/ASX 200 Index has been 11.5%.
[2] A portfolio of 35% ASX 200, 35% MSCI World Index and 30% Bloomberg Global Aggregate Bond Index (hedged AUD) has returned 12.5% this financial year compared to the average financial year of 8.8% since July 1992.