MUTUAL TRUST

# Quarterly Outlook

# The direction of travel

> "Forget trying to pinpoint when the Federal Reserve will cut interest rates. Don't worry about trying to predict where U.S. employment data will come in … It's the direction of travel that matters, not the details."
>
> HOWARD MARKS, CO-FOUNDER OAKTREE CAPITAL, SEPTEMBER 2024

Where are we heading? Conflicting economic data is providing mixed signals. Rather than fixating on individual data releases and speculating on the precise timing and magnitude of future rate cuts by the U.S. Federal Reserve (Fed) and the Reserve Bank of Australia (RBA), we prefer to focus on the direction of travel – which has recently turned.

Higher for longer rates are slowing global economies and monetary policy easing is now underway in many major jurisdictions. Six of the ten largest developed economies have now cut their target interest rates – U.S., Canada, Eurozone, UK, New Zealand and Switzerland. In Australia, the RBA is unlikely to cut rates until inflation falls closer to target despite, experiencing lacklustre economic growth.

The U.S. economy, which has to-date been remarkably resilient, is showing signs of an orderly slowdown but is not sharply deteriorating, for now. Equity markets still appear hopeful the Fed will achieve its elusive 'soft landing' – with the S&P 500 Index fully recovering from its August/September wobbles – reaching a new record high this week. The S&P/ASX 200 index has followed, albeit to a lesser extent. Equity valuations remain elevated, well above historical averages, and potential risks appear underpriced.

However, there is increasing nervousness within investment markets – exasperated by waning optimism for artificial intelligence (AI) companies and the closely contested U.S. presidential election (Tuesday, 5 November 2024). Fund managers are adjusting equity positioning to include more defensive exposures. Seasonally, September and October are historically weaker and more volatile months for equity markets, typically strengthening into the end of the year – these trends can be magnified during U.S. election years.

In our latest Quarterly Outlook, we focus on nine important trends for readers. We address where the economy is heading, the levers of monetary and fiscal policy, important equity market dynamics, and how Mutual Trust is positioning portfolios for the new direction.

# Where are we heading? Orderly slowdown, for now

> "We're trying to achieve a situation where we restore price stability without the kind of painful increase in unemployment that has come sometimes with disinflation."
>
> JEROME POWELL, FEDERAL RESERVE CHAIR, SEPTEMBER 19, 2024

U.S economic growth has so far been remarkably resilient – but recent economic data is providing contradictory messages regarding the outlook. Some technical data indicators have implied an impending U.S. recession (e.g. Sahm Rule, inverted yield curve), while other data suggests economic resilience (GDP growth remains a robust 3% p.a.). Structural factors, such as the normalisation of supply chains after the pandemic and immigration trends, may also skew the data impacting its predictive capability. However, trends are emerging.

## Chart 1: Leading indicators signal loss of economic momentum

The latest U.S. Conference Board Leading Economic Index (LEI) declined for the sixth consecutive month in August (lowest level since 2016), signalling a loss of economic momentum. The LEI combines ten leading indicators – such as manufacturing new orders, building permits, initial jobless claims, weekly manufacturing hours worked – to provide an early indication of significant turning points in the business cycle.

**Loss of economic momentum can become a self-reinforcing spiral. Businesses may pull back on hiring and capital expenditure, and inventories rise.**

## Chart 2: Industrial activity is in contractionary territory; the services sector remains resilient

U.S. industrial activity has been contracting. The U.S. ISM Manufacturing Purchasing Managers Index (PMI) remains in contractionary territory for the fifth consecutive month (for the 21st time in 22 months). The August survey showed that demand remains weak, reflected by New Orders and Backlog of Orders being in contractionary territory. Customer inventories are rising and production levels were reduced in August.

In contrast, the services sector in the U.S. remains resilient and in expansionary territory – with slow to moderate growth cited across many industries.

**The services sector accounts for more than two-thirds of the U.S economy, and therefore is supporting it from sharply deteriorating.**

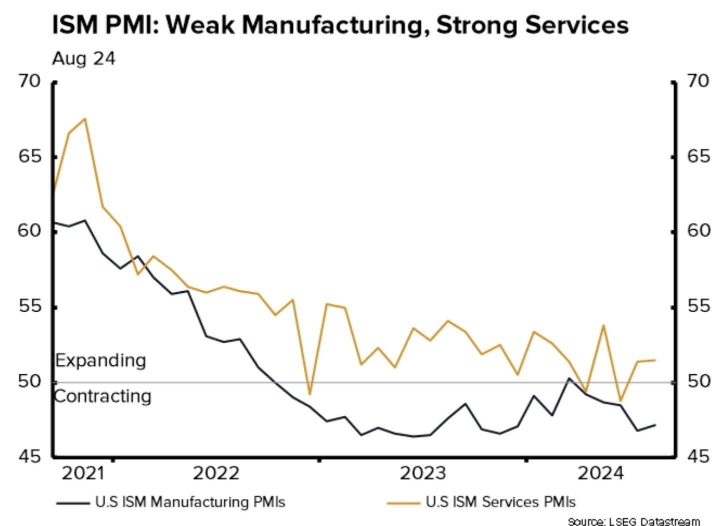
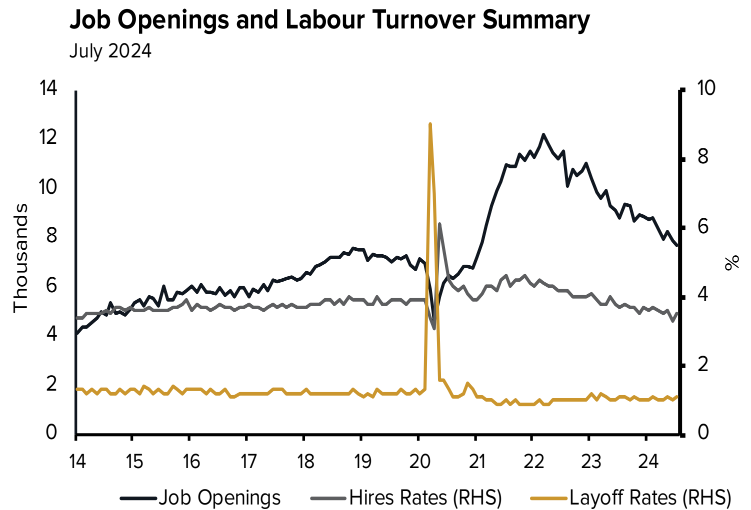


Chart 3: Employment data is cooling to more normalised levels

> "Clearly payroll job creation has moved down over the last few months, and this bears watching."
>
> JEROME POWELL, FEDERAL RESERVE CHAIR, SEPTEMBER 19, 2024

**In setting monetary policy, the Fed has a dual mandate – stable prices and maximum employment. Now that inflation has fallen close to target levels, the labour market is in focus – the trend in leading indicators shows evidence of cooling, consistent with an orderly slowdown.**

The U.S labour market is normalising and now better balanced. Unemployment has risen off its historic lows (3.4%) to 4.2%. A sudden spike in unemployment is unlikely while growth and corporate earnings remain healthy. Meanwhile, there have been no signs of mass layoffs – although this is a late cycle indicator. After the extreme tightness in the labour market experienced during the pandemic, employers have generally been reluctant to let staff go due to re-hiring concerns.



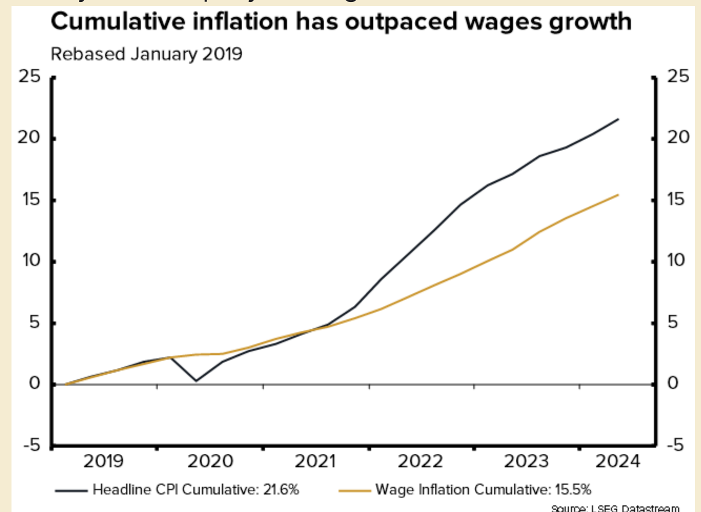

However, the number of jobs added to the U.S. economy (measured by non-farm payrolls data) has moved down and was below expectations in August (with prior months revised lower). Weekly hours worked is trending lower – a sign of slowing labour demand.

**Importantly, the trend in leading indicators such as Job Openings and Hire Rates have declined, albeit to more normalised levels.**

Chart 4: Australia - The cumulative effect of inflation matters

**As the RBA continue to hold rates, the outlook for the Australian economy and company earnings looks lacklustre. Net immigration and fiscal policy are providing some support.**

Economic growth is at its lowest levels since the 1990s recession (excluding the pandemic) with GDP growth just 0.2% in the June 2024 quarter. Excluding population growth, we are in a per-capita recession with **GDP shrinking 0.4% – the sixth consecutive quarterly fall.**




Australian consumers are feeling the dual effects of higher for longer interest rates and the *cumulative* effect of inflation.

Although economist measures of inflation have fallen from the 2022 peak to 3.8% in the June quarter, this is not where households focus. **The cumulative increase in the average price of a basket of goods and services is over 21% since 2019.** To the average consumer, goods and services are much more expensive. By comparison, wages have increased by 15.5% over the same period.

Fiscal policy is partly helping to support the economy – government spending by State and Federal Governments is driving growth in public demand, rising to a record high 27.2% of GDP in in the June 2024 quarter. Stage 3 tax cuts are three months into working their way through the economy, together with other cost-of-living initiatives. Meanwhile net migration remains elevated at circa 400,000 annualised. **As Australia struggles to reduce inflation back to target levels, these fiscal measures can make monetary easing by the RBA harder, with rates cuts unlikely before February 2025.**

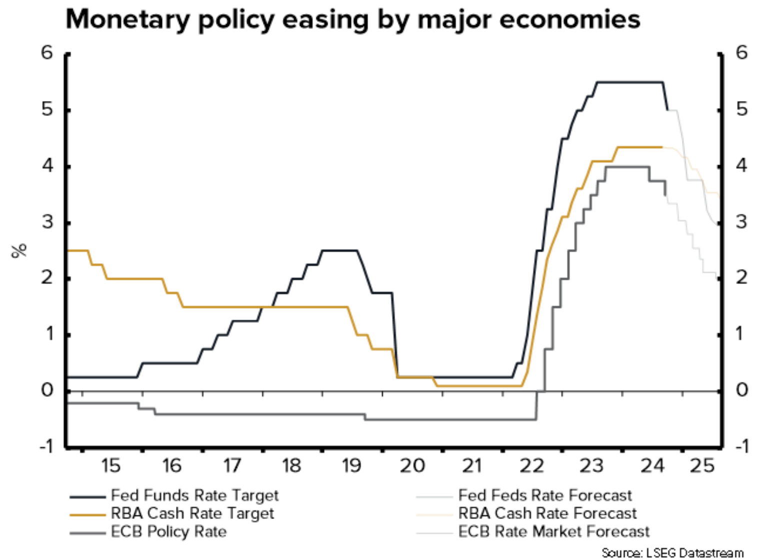
# Monetary and fiscal policy levers to cushion any fall

**Although economies are slowing, the dual monetary and fiscal policy levers have potential to steer economies away from a recession – this is far from certain and warrants some caution in portfolios, especially given elevated valuations.**

## Chart 5: Policy easing is underway – major developed market central banks are cutting rates

The direction of travel has shifted, monetary policy easing is underway. In September, the U.S. joined other nations, cutting their target cash rate by 50 basis points. Six of the ten largest developed economies have now started easing policy (U.S., Canada, Eurozone, UK, New Zealand and Switzerland).

A cut of 50 basis points is the strongest evidence yet that the Fed is very attuned to risks to economic growth and employment. Cuts of this size have traditionally only been used in emergencies – in January 2001, as the dotcom bubble was bursting; in September 2007, when the GFC was just gathering pace; and in March 2020 at the onset of the pandemic.




From here, the Fed has plenty of room to cut rates further. Bond markets are pricing in almost 2% of rate cuts over the next 15 months. Regardless of exact timing, the direction of travel is clearly towards monetary easing and loosening of financial conditions to help maintain the strength of the economy.

**Meanwhile, both sides of U.S. politics, regardless of the election outcome, are pro stimulus and potentially inflationary** – albeit likely more so under former President Donald Trump (Republican). Together with his planned extension of the 2017 tax cuts (due to expire in 2025), Trump's tighter stance on immigration and his proposed tariffs could raise prices for American consumers.

**If inflationary trends tick upwards again, the Fed may not be able to cut rates as swiftly as markets are currently pricing. In such a scenario, this may pose a risk for equity and bond markets.**

## Chart 6: Equity market performance after the initial Fed rate cut – pre-emptive versus reactive

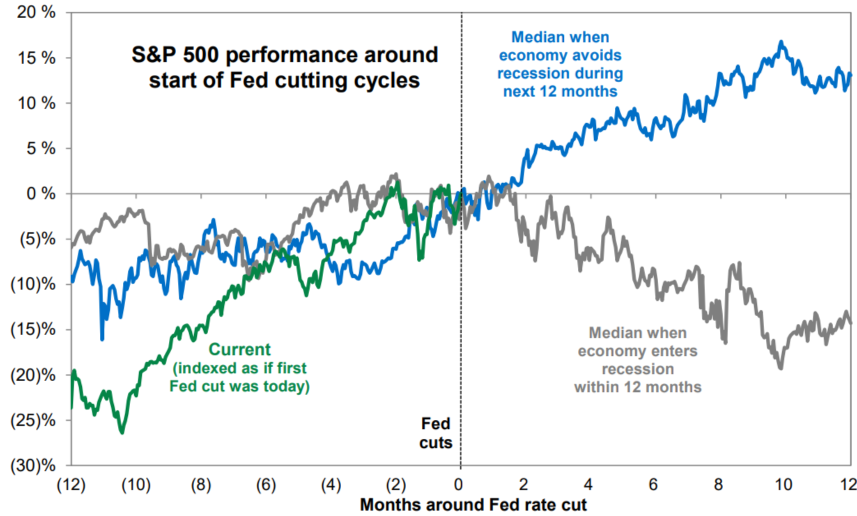
Investment markets react in various ways after an initial Fed rate cut.

- If the cut is viewed as **pre-emptive**, thereby avoiding a recession and achieving a 'soft landing', equities typically move higher. A soft landing is relatively uncommon. Over the past six easing cycles since 1989, we identified only two episodes – in 1995 and 1998 — where the Fed managed to avoid an immediate economic downturn.
- If the cut is viewed as **reactive**, coming too late and a recession ensues, a market sell off occurs.

However, there is significant performance divergence over previous cycles. Performance ultimately depends on the direction of economic growth and health of the labour market.

**We expect market to be highly sensitive to any disappointing data. This provides rationale for taking some caution with equity market positioning.**

**S&P 500 Index performance post initial rate cut – recession vs no-recession**




Source: Goldman Sachs Global Investment Research

# Market dynamics – AI exhaustion, risk appetite and seasonality

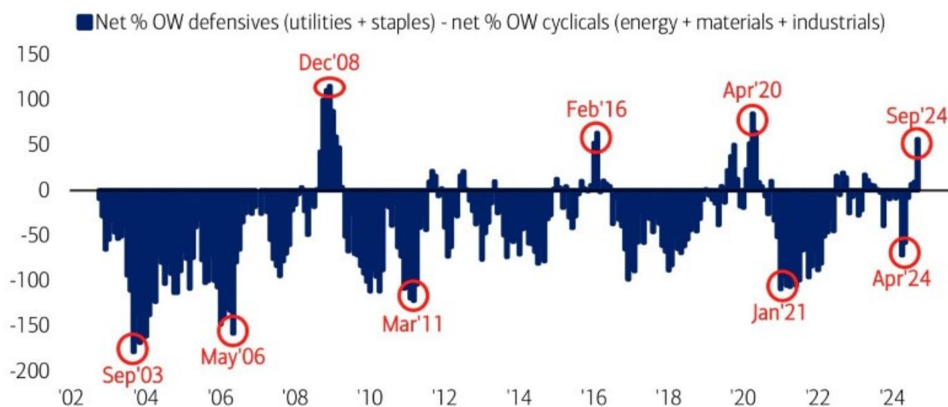
Nervousness around both the economic situation and the disruption to leadership away from mega-cap technology poses risk to the outlook for equities. Meanwhile, volatility has historically risen into U.S. election day, recovering over the following months.

Chart 7: Fund managers overweight equities, but reflect nervousness with a drop in risk appetite and rotation towards defensive assets

The S&P 500 Index is up 29% over the past year and is trading on 23.5 times forward price to earnings ratio – well above its 20-year average of circa 18 times. This is despite economic uncertainty. According to the Bank of America Global Fund Manager Survey, global investor sentiment improved in September – on optimism around a soft landing for the U.S. economy and interest rate cuts by the Fed. 52% of fund managers believe there will be no recession for the U.S economy in the next 18 months, although global growth expectations remain pessimistic.

Fund managers maintained their overweight position to equities, after a reduction in August. However, there is evidence of nervousness – the survey showed risk appetite is at an 11-month low and there was a marked shift in the composition of equity portfolios towards defensive assets such as utilities, consumer staples and healthcare (away from technology, energy and industrials). They are the most overweight defensives since May 2020.

**Fund managers have largest overweight to defensives since May 2020**




**Source:** BofA Global Fund Manager Survey

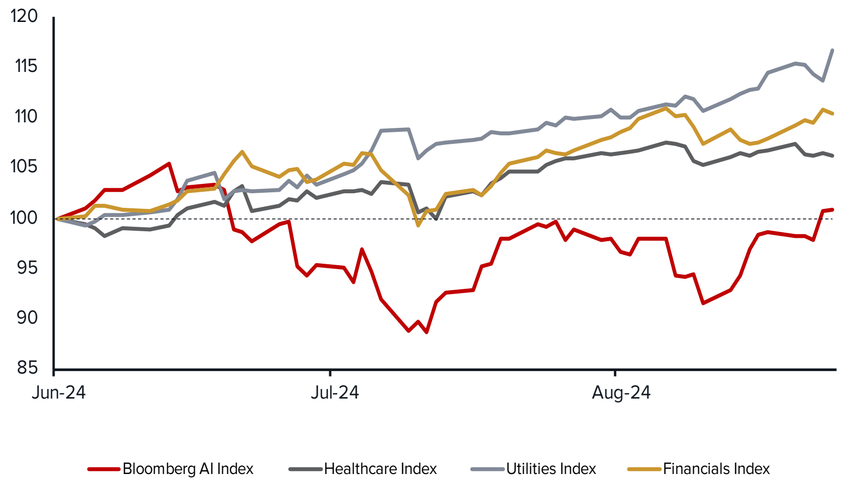
## Chart 8: Signs of exhaustion with the AI trade – recent rotation into value and defensive sectors

**There are some signs of exhaustion with the AI trade driven by lofty valuations and scepticism around the ability to generate sufficient returns from the significant capital expenditure towards AI innovation. Even small reductions to earnings expectations have driven meaningful weakness to the share prices of these dominant companies and driven a shift in market performers.**

While macro-economic trends are relevant, it is still the U.S. technology giants which are setting the tone for overall equity market performance. A rotation away could cause a major pullback in equities given their concentration in the S&P 500 Index is at historical highs.

Over the past quarter there has been a disruption to index leadership, with a stark contrast in sector performance versus the first half of 2024.

The Bloomberg AI Index significantly outperformed the S&P 500 Index during the first 6 months of the year. However, since July the AI index has underperformed, rising just 0.85% (with high volatility) versus the S&P 500 Index 4.4% higher. During this period, the market experienced a rotation into value and defensive orientated sectors such as healthcare, banks, utilities and REITS, which outperformed.

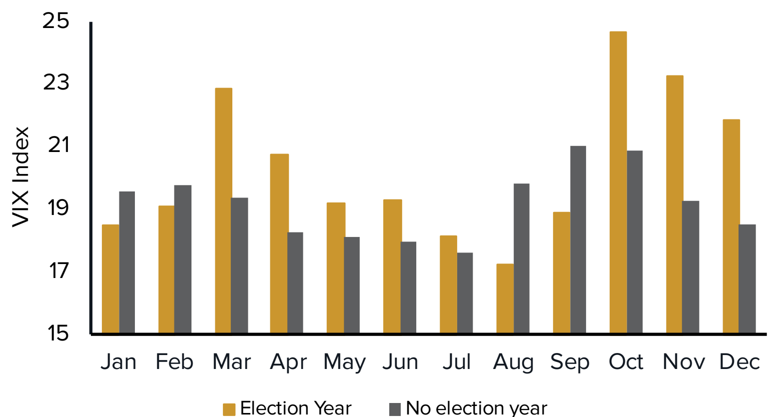



Source: Bloomberg, rebased 28 June 2024

## Chart 9: Politics should not influence investment decision making, but be mindful of rising volatility into U.S. election day

**September and October have historically been weaker and more volatile months for equity markets, even more so in election years (on average, over the past 33 years).**

The U.S. Presidential election on Tuesday, 5 November is fast approaching. At Mutual Trust, political uncertainty does not influence our investment decisions – we prefer to focus on longer-term fundamentals. However, we recognise that volatility has typically risen into election day, especially under a contested scenario. The odds for the winner are close (latest CBS News polling shows support for Harris at 52% versus Trump 48%). Markets do not like uncertainty.




Source: Bloomberg, data range from 1990 - 2023

Post election in November and December, as some sense of certainty re-establishes itself, this may prove temporarily supportive of markets – until investors return their focus to longer-term fundamentals. This is aligned with the historical trend of positive performance, on average, during the final two months of the year.

MUTUAL TRUST

## Portfolio positioning for the direction of travel

We maintain a long-term perspective.  We expect heightened volatility as markets adjust to a new direction of travel – easing of monetary conditions and uncertainty around slowing growth.  Attractive opportunities will arise, and we recommend a consistent deployment of capital while being opportunistic in times of market stress.

- We reinforce our view to remain predominantly invested in risk assets as part of a well-balanced portfolio over the long-term, and selectively increase exposure to alternative asset classes, including unlisted infrastructure, private credit and private market equity.
- Our portfolios maintain a moderate underweight position to equities as uncertainty remains heightened, valuations elevated, and forward indicators point to softening growth.  Potential risks appear underpriced.
- Our international equity portfolio offers diversified exposure across various sectors – including financials, technology, healthcare – with leverage to major positive global thematics.  We recently added U.S. energy and critical minerals exposure.  We favour companies able to deliver earnings growth through various market environments with strong cash flow generation and propensity to return capital to shareholders.
- We have not increased our fixed income (government bonds) exposure to overweight at this stage.
- We expect a high dispersion of returns across and within sectors and therefore favour active management across all asset classes and focus on high quality, well researched investments.

Please reach out to your Mutual Trust Advisor for more details.

MUTUAL TRUST

**Melbourne**
Level 32
360 Collins Street
Melbourne VIC 3000
T +61 3 9605 9500

**Sydney**
Level 18
126 Phillip Street
Sydney NSW 2000
T +61 2 9224 7600

**Perth**
Ground Floor
22 Stirling Highway
Nedlands WA 6009
T +61 8 9230 7700

**Adelaide**
Level 2
28 Franklin Street
Adelaide SA 5000
T +61 8 7082 3900

info@mutualtrust.com.au
www.mutualtrust.com.au

Liability limited by a scheme approved under Professional Standards Legislation. For participating members (other than for the acts or omissions of Australian Financial Services Licensees).  This information is general in nature and has been prepared without considering any particular person's objectives, financial situation or needs. It does not constitute and should not be relied upon as personal financial product, taxation or legal advice. Before making any investment decision you should read the relevant product disclosure statement or other disclosure document and obtain personal financial, taxation and legal advice.  For a copy of our Financial Services Guide, please visit our website at mutualtrust.com.au.

Prepared in Australia by Mutual Trust Pty Ltd (ACN 004 285 330) (AFSL 234590).

Mutual Trust acknowledges and pays respect to the past, present and future Traditional Custodians and Elders of this nation and the continuation of cultural, spiritual and educational practices of Aboriginal and Torres Strait Islander peoples.

© 2024 Mutual Trust Pty Ltd.