

# Market Update

## View from the Investment Team

June 2024

### Summary

**Global share markets performed strongly over the month of June, led by the US and the technology sector. Bond markets in Australia and the US also gained marginally in value as bond yields fell slightly, although they were rising again into mid-year.**

**The Canadian Central Bank and the European Central Bank both cut interest rates in June by 0.25%. It is not expected to be the start of aggressive cutting cycles.**

**Australian super funds finished the financial year with above average returns (circa 10%+), driven by lower inflation, stable economic growth, and huge AI-related outperformance.**

### MARKETS

Global equity markets rose by approximately 2.3% (in local currency terms) in June to round out a remarkable 20%+ gain for the last 12 months. The US and Japan were stand outs while Australia, Europe and Emerging markets lagged at around half that over the financial year.

Poorly performing markets during the 2024 financial year were China at approximately -8%, Australian resources sector at around -3.2%, and direct real estate at around -5.6%.

Nvidia rose to become the largest company in the world mid-June before suffering a 12.9% correction and falling back to third behind Microsoft and Apple (where it currently sits). It still rose over 12% during the month.

India completed its election and Narendra Modi was elected to his third term, although for the first time heading a coalition government. 645 million people voted, almost half of whom were women, the highest ever turn-out. The shock of the coalition requirement saw the Indian share market fall over 6%, it has recovered since and is up over 17% year-to-date.

Australian house prices have risen over 8% over the last year, led by Perth at over 23%, whereas Hobart was marginally negative. The market remains supported by a shortage of houses appears to be set to remain under pressure given lower construction starts, while affordability remains very low and is deteriorating.

Global earnings expectations remain at around 11% for 2024 and 13% for 2025. Emerging markets sit higher than that at around 21% and 15% respectively, while developed markets are slightly under. Laggards include Australia at 0% this year and 3% next. Australia's valuations however sit above Europe, Japan, the UK, Asia ex-Japan and emerging markets. Australia's earnings headwinds are courtesy of the energy, materials, and banking sectors.

## DATA AND EVENTS

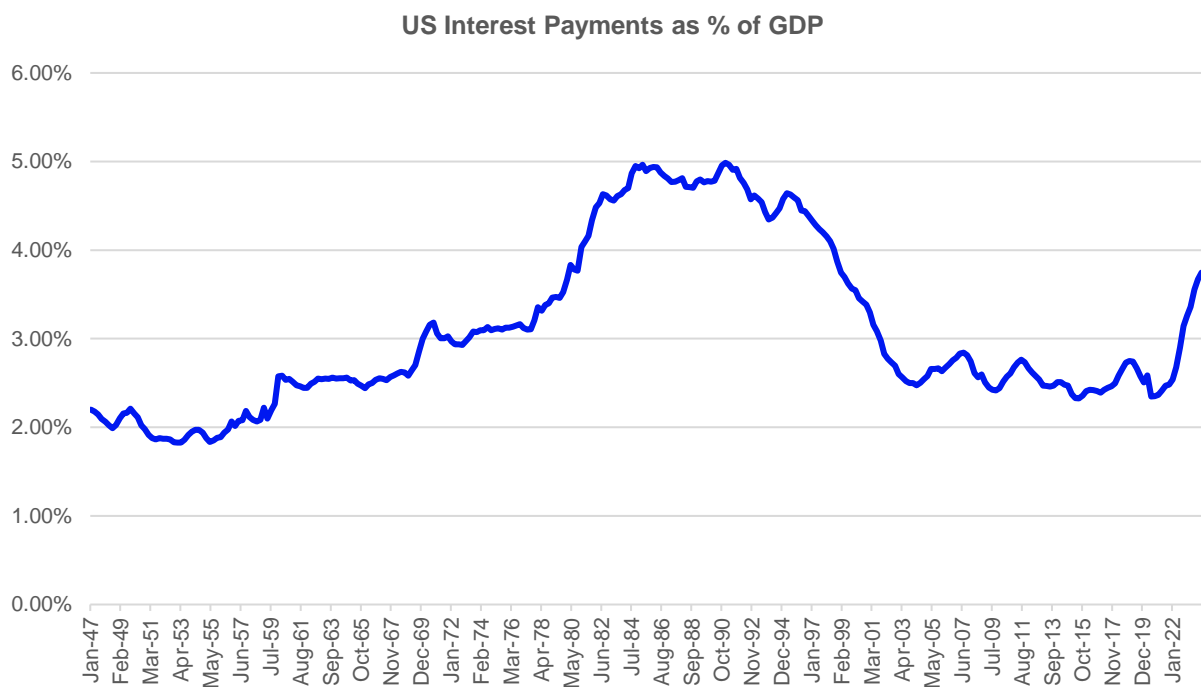
Australian economic data has remained on the weaker side and continues to come in below expectations (on average). Purchasing Managers Index (PMI) surveys moved into contractionary territory (below 50) while services also moved closer to contraction. Australia's expected inflation rate for 2024 remains slightly elevated at 3.4%.

US data also remains on a softer than predicted path. Notably the actual levels are also weakening on average (as opposed to the difference to expectations). Job openings are softer again and coming back into line with available workers, or at least the same levels as pre-pandemic. Jobless claims and new jobless claims are all pointing toward some weakening in the labour market. Inflation readings have been in line with or softer than expectations but above targets, prompting further talk of patience from the Fed. Inflation remains at around 3.4% for headline and 2.6% for PCE.

European data has been improving somewhat, with gross domestic product (GDP) growth for 2024 increasing again to around 1%. Inflation is below 2.5% and PMI readings are to around 0.7-0.9% for this year. PMI data is slightly improving however manufacturing remains weak.

## CHART OF THE MONTH

Higher interest rates hurt most of us in the end. The US government is growing its interest bill at a record rate, and it will move higher as some of the debt is rolled over. In addition to concerns that a new Republican government will (if elected) increase deficits further, there's potential for a bond rout similar to the UK's in 2022.



Source: FRED

## **KEY THEMES**

### **1. AI and earnings**

The old adage about selling shovels in a gold rush seems pertinent to today's incredible run in AI-related stocks. Nvidia is the seller of the best shovels, and everything related to them, and their customers are large corporations with deep pockets who are in a hurry to invest. Large tech companies are spending more than \$1 trillion AI capex in the next few years, raising questions over the return that can be expected from that investment. Sceptics argue generative AI is too expensive to run, consumes too much power from an ageing infrastructure grid, chips are complicated and limited in production, and that AI doesn't have a killer application and that productivity gains will be limited by this. Proponents would argue that new technology always finds its way into productivity eventually and that current investment levels aren't that different to history when compared to current revenues. That leaves a likely scenario of a continuation of winners (AI infrastructure providers), but with risks around growth projections, but also a still developing narrative about long-term winners. Meanwhile, the global IT sector is expected to produce earnings above 20% this year and next. The global tech equipment sector (chips) is expected to produce earnings of above 35% in both years.

### **2. Credit pricing**

Credit spreads, or the amount an investor gets compensated for the risk of default, are quite tight relative to their history. Investment grade bonds in the US are providing additional yields over treasuries of around 0.9% (numbers vary depending on the type of index chosen), while high yield bonds are offering around 3.1%. That sounds ok, except that the amount required historically to compensate an investor in the US for default rates in high yield is around 2.5-3.5% (this varies by time period, recovery rates in default and credit quality levels). So basically, in high yield you aren't getting much more for your risk, unless defaults stay low. The good news is that corporate defaults are low at present. Generally high profitability and accessing longer-term cheap financing when interest rates were low has helped corporates weather rate rises. Heading into 2025 and beyond, as refinancing activity picks up and assuming interest rates do not fall rapidly, that stress will rise. Over the next 3 years 30% of all fixed rate debt matures. In addition, interest rate coverage, or the ability to pay ongoing interest payments, is now declining, albeit from healthy levels.

### **3. Private equity**

Private equity funds locally have enormous amounts of 'dry powder' or funds committed and available to invest. Across all types of private equity, funds committed has risen to \$3.9 trillion, a third of which is in buyout funds. At the same time, the industry is still working through the backlog of assets that remain unsold and are aging in portfolios, itself a hangover from the post pandemic liquidity boom. That figure is around \$3.2 trillion. Higher interest rates are pressuring those valuations somewhat and private equity funds will need to be creative and almost certainly take lower prices in order to clear these assets from portfolios. That puts secondaries (funds that buy from other funds at a discounted price) in a good position. It also

warrants caution on the debt backing many of those assets, which has increasingly come from direct lenders.

#### 4. US election

The US presidential election was thrown into disarray (for Democrats at least) after a poor debate performance from Joe Biden on 27 June, raising concerns about his ability to continue to run. Betting market reactions moved in favour of Kamala Harris becoming the nominee. Apart from already being vice president, Harris has several other things in her favour including access to (inherit) Biden's campaign funds as she is already on the paperwork, and a better polling rating against Trump than all other candidates. Market reaction after the debate offered some insight into how markets would react to a Republican win. Longer-term bond yields rose, as did the US dollar and bitcoin. The Republican growth agenda, and the current state of US government debt and its cost, suggest potential weakness in long-term US bond prices.

#### 5. Financial stability

During the month the US Federal Reserve released stress tests results for 31 large US banks. The tests showed that these banks remain well capitalised and even under the severe stress conditions, capital buffers would remain above the minimum levels. For context, a severe test includes unemployment rising to 10%, a 36% decline in house prices and 55% drop in equity prices. The main weaknesses came from higher credit card balances (where delinquencies are already rising) and riskier corporate credit portfolios. Importantly, the conclusion was that banks could keep lending as normal and that they would weather severe write-downs in commercial property values. What wasn't tested was regional banks and their (higher) concentrations to real estate debt. Those risks remain and are likely to see high stress in specific cases, but the overall banking system appears resilient.

### MARKET RETURN SUMMARY

Asset class (% change)	1 month %	3 months %	1 year %	3 years (% p.a.)
Australian shares	1.01	-1.05	12.10	6.37
Smaller companies	-1.39	-4.46	9.34	-1.55
International shares UH	1.61	0.28	19.92	11.18
International shares H	2.29	2.95	20.23	7.03
Emerging markets UH	1.61	0.28	19.92	11.18
Property – Australian listed	0.39	-5.63	24.65	5.74
Property – global listed	0.83	-1.56	3.59	-4.81
Infrastructure - global listed	-2.72	-0.29	2.86	1.12
Australian fixed interest	0.77	-0.84	3.68	-2.06
International fixed interest	0.78	-0.16	2.67	-2.74

Source: Morningstar Direct. Returns are shown on a total return basis as at 30 June 2024. Past performance is not a reliable indicator of future performance.

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