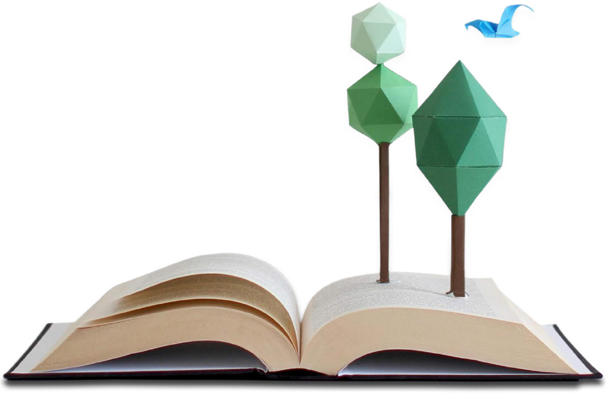
Mercer welcome to brighter

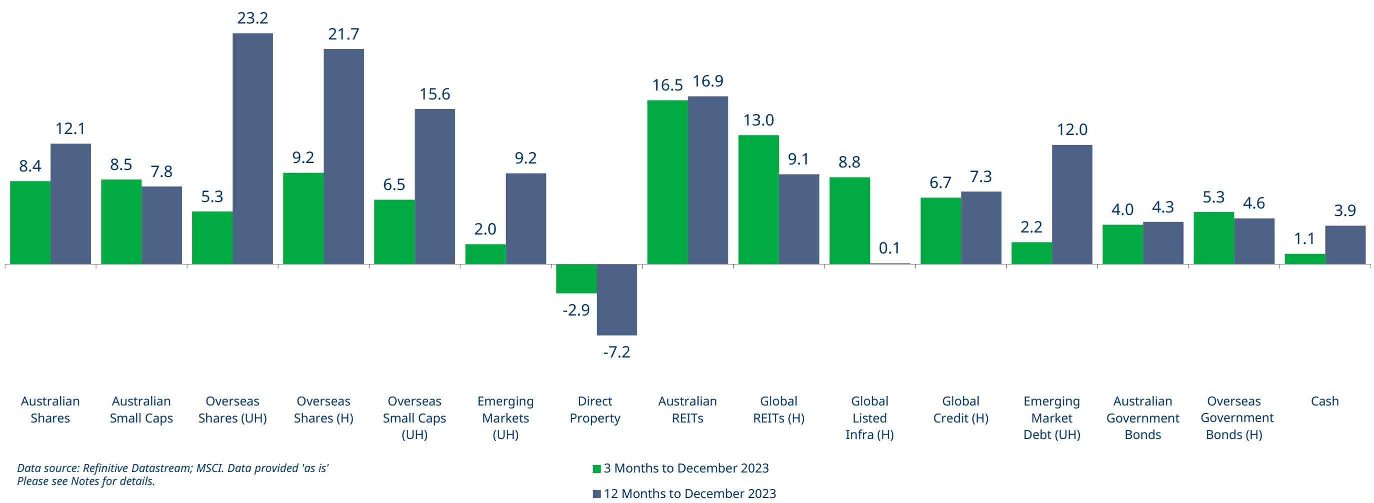
Q4 2023

Market and economic conditions



Selected market indicators commentary

Asset class returns as at December quarter 2023



Economic overview

Over the December quarter (Q4) economic indicators released indicate that growth is remaining positive despite the rise in interest rates to this point. The latest NAB Business Survey results continue to show resilience in business conditions, although there was some easing evident in the survey particularly in the mining, transportation, utilities, and construction sectors. Other business surveys suggest softer conditions, especially among small-to-medium-sized businesses. Meanwhile, house prices have continued to rise with a 1.5% quarter-on-quarter (QoQ) increase in Q4, resulting in a total rise in prices of 8.1% over 2023. This growth has been supported by a tight labour market, with unemployment remaining low at 3.9% in November. Population growth and consumer resilience have also contributed to this growth, although there are signs of slowing due to the delayed impact of high interest rates.

The Year-on-Year (YoY) inflation trend, measured by the monthly Consumer Price Index (CPI) indicator, was 4.3% p.a. in November, slowing from the 4.9% p.a. reported in October. This slowdown was driven by a decrease in food, transport and fuel prices, as well as the appreciation of the Australian dollar against other major currencies. In terms of monetary policy, the Reserve Bank Australia (RBA) raised its cash rate by 0.25% to 4.35% p.a. in November, reaching the highest level since November 2011. However, in the final meeting of the year the RBA decided to leave interest rates unchanged. The December meeting minutes revealed that the board had considered raising interest rates by 0.25%, but ultimately chose to keep rates unchanged due to the “encouraging signs” on inflation and the risk of a faster-than-expected rise in unemployment.

Outside of Australia data releases over the past quarter have shown diverging trends in different regions. In the Eurozone business activity remains weak. The survey of the manufacturing sector continued to show contraction during the quarter, with declining output and job losses persisting for the seventh consecutive month. The service sector also remained in contraction for the second consecutive quarter, as demand for Eurozone services declined at the end of the year and employment growth slowed. In the US economic data continues to show resilience. Business activity, as measured by the US Institute for Supply Management (ISM) Manufacturing Purchasing Manager's Index (PMI), remained in contraction. However, the services sector, measured by the US ISM Services PMI for December, remained in expansionary territory at 50.6, indicating growth. Meanwhile, core inflation is still easing in many developed economies, although at varying rates. Core inflation in the Eurozone cooled to 3.4% YoY in December and 3.9% YoY in the US, marking their lowest readings since March 2022 and May 2021, respectively.

On monetary policy, the Federal Reserve (Fed) kept interest rates steady at 5.25 - 5.50% p.a. with Fed Chair Jerome Powell noting that discussions of rate cuts had started. Meanwhile, the European Central Bank (ECB) also kept interest rates unchanged at their December meeting (i.e., 4.5% p.a. for the main refinancing operations) with ECB President Lagarde noting that "it was not the time to lower [our] guard" in the accompanying press conference. The Bank of Japan (BoJ) maintained its policy rate at -0.1% p.a. following the earlier loosening of the yield curve control policy in the quarter.

Market review

Global equities rose in most regions in the fourth quarter of 2023, primarily driven by a decrease in bond yields, especially after the comment from the Fed Chair Jerome Powell noting that discussions of rate cuts had started, and geopolitical tensions had eased. The Australian share market also followed this trend, with a notable increase of 8.4%. The rise in risk appetite and lower bond yields led to a strong performance in the Materials, Real Estate, and Healthcare sectors.

Government bond yields ended the December quarter lower following more dovish signals from the US Federal Reserve and the US treasury announcing a lower-than-expected increase in the issuance of longer-dated bonds, with the US 10-year government bond yield declining by 71bps to 3.87% p.a. Similarly, the Australian 10-year yield decreased by 59bps to 3.90% p.a., as the local market anticipates that the RBA will cut interest rates in 2024. This anticipation was backed by the weaker GDP data for Q3 and moderation in business confidence. The Australian dollar (AUD) appreciated against the weakening US dollar (USD), with the Fed's rhetoric shifting market expectations.

Commodity markets showed mixed performance over the December quarter. Oil prices continued its downward trajectory, dropping by 18.6% to its six-month low of US$77.69 per barrel in December, attributed to the weakening global demand and the strength of non-OPEC oil supply. Industrial Metals prices were stronger over the quarter, Iron Ore gained 19.2%, driven by positive sentiment towards the recent developments in the Chinese economy and support for China's housing market. Similarly, copper prices (S&P GSCI Copper) rose by 3.8% during the quarter, fuelled by optimism for further stimulus announcements in China and signs of improvement in factory activities in the country. In the precious metals sector, gold prices also rose by 11.2% to US$2,065.45 per ounce, attributed to the weakening of the USD and the growing anticipation of interest rate cuts in 2024.

Market outlook

Several factors have supported economic growth in Australia recently, including households spending their excess savings, an increase in population growth by immigration, a significant proportion of mortgages on (low) fixed rates, and government spending. However, we expect growth to moderate in the future as these factors gradually diminish and higher interest rates have a bigger impact. Inflation is also expected to slow, although not as quickly as in other developed economies due to pressures from residential rental markets. The risks point towards a more severe slowdown in activity compared to expectations as reflected in the current market pricing of interest rates. While the market predicts two interest rates cuts in 2024, we believe that more cuts are likely and will happen sooner.

Globally, we anticipate resilient growth, although it will vary across regions. Major developed economies are expected to experience a moderation in economic conditions due to tighter financial conditions and the impact of higher interest rates on households and businesses. On the other hand, China is expected to see stronger growth driven by supportive fiscal, monetary, and regulatory policies, as well as a turnaround in the manufacturing inventory cycle and a potential stabilisation in the housing sector. Other emerging economies are also expected to benefit from their central banks easing monetary policy settings.

In terms of asset class perspectives, we maintain a cautious view on developed markets due to their high valuations and optimistic earnings outlook. We have a favourable view on emerging markets, which offer attractive valuations and more promising economic prospects. In the domestic market, considering the relative risks associated with interest rate expectations, we find Australian Sovereign bonds attractive, despite the persisting risks posed by the volatility of global sovereign bond markets and their impact on our market.

Asset class comments

Australian Equities

Australian shares delivered a strong performance over the December quarter, with the S&P/ASX 300 Index returning 8.4%. This performance can be attributed to the market's expectations shifting to reflect lower interest rates in 2024 and a soft landing of the US economy. Additionally, the shift in interest rate expectations for 2024 has led to support for both large and small-cap stocks, with the ASX Small Ordinaries index also gaining 8.5% over the period.

The Materials sector outperformed in Q4, returning 13.2%, driven by stronger commodity prices at the same time general risk sentiment remained favourable. BHP Group, RIO Tinto, Fortescue and James Hardie were among the names contributing to the sector's performance. Real Estate and Healthcare also continued to perform strongly, with returns of 16.6% and 13.3% respectively for the period. CSL was a key contributor in the Healthcare sector, as investors considered whether the market had overestimated the adverse impact from GLP-1 diabetes and weight loss drugs. Meanwhile, Energy (-9.0%), and Utilities (-2.1%) were the only two sectors with negative returns over the period. This was due to investors rotating away from defensive stocks, and energy stocks lagging as oil prices continued to decline.

Global Equities

The MSCI World ex Australia Index performed strongly over the quarter, returning 9.2% in hedged terms and 5.3% in unhedged AUD terms. Positive global equity market sentiment was boosted by the rapid repricing of interest rate cuts in the US for 2024, combined with softer inflation data from around the world. Reinforcing investor views that a soft landing of the global economy is more likely in 2024.

Real Estate (10.6%) and Industrials (7.7%) sectors had positive returns over the December quarter, with Information Technology (11.2%) stocks leading the way and delivering the strongest return as investor appetite for interest rate-sensitive assets increased and bond yields declined. Conversely, the Energy (-9.3%) and Consumer Staples (-0.4%) and Healthcare (-0.1%) sectors were the only three sectors with a negative return during the quarter, with the performance of the Energy sector primarily driven by a decline in oil prices.

The MSCI Emerging Markets Index also had a positive return over the December quarter (2.0%) but continues to lag developed global equity markets. China's equity markets, as measured by the SSE Composite (-4.4%), underperformed by a considerable margin compared to most other countries. The performance was primarily driven by investor concerns about the country's economic recovery, which weighed on sentiment.

From a country perspective, the risk-on sentiment was evident in the outperformance of the US market, with the S&P 500 Index (11.7%), the Dow Jones Industrial Average (13.1%), and the NASDAQ Composite Index (13.6%), all up in USD terms supported by economic data that demonstrates the remarkable resilience of the US economy compared to most other countries and the change in Fed rhetoric. European markets were mostly higher (in local currency terms), with the CAC 40 (France, 5.9%), DAX 30 (Germany, 8.9%), and FTSE 100 Index (UK, 2.3%) over the quarter. Equity returns were mixed across Asia, with TOPIX (Japan, 2.0%) and the S&P BSE 500 (India, 12.1%) experiencing a positive return in local currency terms, with investor appetite remaining supportive of the country's strong economic performance. It was a more challenging quarter for and the Hang Seng (Hong Kong, -3.9%) and SSE Composite (China, -4.4%) however with market participants remaining unconvinced by the tentative signs of improving economic momentum in China.

Real Assets

Domestic listed property (S&P/ASX 300 A-REIT Accumulation Index) experienced a significant increase of 16.5% over the December quarter, while Global REITs (FTSE EPRA/NAREIT Developed, in AUD hedged terms) rose by 13.0%. The positive returns for both indices were primarily driven by growing expectations of softer monetary policy settings and interest rate cuts in 2024. These factors are seen as beneficial for real estate earnings and property valuations.

The Australian unlisted property sector (MSCI/Mercer Core Wholesale Property Fund Index – Pre Fees) saw a -2.8% total return over Q4 2023. The negative performance was primarily driven by negative revaluation movements across all sectors in December, resulting in a capital return of -3.9% for the index. However, this was partially offset by a total income return of 1.1%. Notably, Industrial funds underperformed during this period, with a total return of -5.0%. The Office sector continued its decline with a total return of -3.4%, while the Retail sector remained relatively stable with a total return of -0.9%. Valuers attribute these write downs to higher interest rates and ongoing economic uncertainty, despite limited transaction evidence during the period.

Fixed Interest

Global sovereign bond performance was mostly positive over the December quarter. The yields on 10-year bonds decreased in the US (-71bps to 3.87% p.a.), Germany (-81bps to 2.03% p.a.), the UK (-88bps to 3.57% p.a.), and Japan (-13bps to 0.62% p.a.). After a rough start in the quarter, where the US 10-year bond yields reached the 5.0% p.a. mark in October, yields declined in November and December as the market's expectations of central banks reducing interest rates soon were reinforced by weaker economic data and central banks themselves. Following the Fed's 'higher for longer' message that resonated in the markets in October, the softer economic data in the US and Powell's more dovish remarks in December, where he noted the Fed's consideration of interest rate cuts, led to a decline in US bond yields. Meanwhile in the Eurozone, data momentum has remained weak. In the UK, economic growth data was revised down and inflation in November softened, further supporting the overall rally in markets. On the other hand, the Bank of Japan kept interest rates unchanged, after loosening the yield curve control policy earlier in the quarter, while the market expectations of rate hikes this year remained.

The FTSE World Government Bond (ex-Australia) Index returned 5.3% over the quarter and the Bloomberg Global Aggregate Bond Index both returned 5.4% on a fully hedged basis. Credit spreads widened earlier in October due to the risk-off sentiment following elevated government yields and global uncertainty in the context of the Middle East conflict. However, spreads tightened later in November and December as market participants shifted their expectations towards a soft-landing scenario for the US economy, while lower levels of issuance compared to high demand for higher yielding investment-grade bonds, was also a support.

Domestically, bond yields across maturities declined in line with the global bond markets, resulting in a fall of -59bps in the Australian 10-year bond yield over the quarter, bringing it to 3.90% p.a. Consequently, the Bloomberg Ausbond Treasury Index gained 4.0%. The domestic credit market, as tracked by the Bloomberg Ausbond Credit Index, also experienced gains of 3.2% over the quarter. The decline in local bond yields in the last two months of the year was explained by the market's expectation of the RBA cutting interest rates in 2024. This anticipation was supported by weaker GDP data for Q3 and moderation in business confidence.

Currency Markets

The AUD appreciated against most major developed market currencies over the December quarter. The AUD was stronger against a weakening US Dollar (5.7%) as mixed US data shifted market expectations, pricing in an end to the Fed's tightening cycle.

Following a rebound in short-term price pressures during the September quarter and ongoing inflationary pressure, particularly in the services sector, the RBA decided to increase the interest rate by 0.25% to 4.35% p.a. during its November meeting. However, in its final meeting of the year in December, the RBA decided to hold interest rates steady at a 12-year high. Higher interest rates, along with the rise in prices for Australia's commodity exports, has contributed to the appreciation of the Australian dollar. As a result, the AUD has strengthened against the UK Pound (1.2%) and Euro (1.3%), and on a trade-weighted basis, the local currency has strengthened by 2.5% over the quarter. Meanwhile, the AUD has remained relatively unchanged against the Yen (-0.1%).

Commodities

The S&P GSCI Commodity Total Return Index experienced a decline of -15.6% during the December quarter. The energy sector, specifically oil prices (measured by Brent Crude), was a major contributor, dropping by 18.6% over the quarter to US$77.69 per barrel. The decline in price was attributed to weakening global oil demand, following weaker demand for industrial fuels, LPG and lower seasonal uptake in heating oil in light of a milder winter across the Northern Hemisphere, coinciding with the strength of non-OPEC+ supply.

Meanwhile, Industrial Metals ended Q4 higher. Iron Ore gained 19.2%, largely driven by recent developments in the Chinese economy and the new support for China's housing market. Similarly, copper prices (S&P GSCI Copper) rose by 3.8% over the December quarter following optimism around the prospects for further stimulus measures in China and signs of improvement in factory activity in the country. Gold prices increased by 11.2% over the quarter to US $2,065.45 per ounce, attributed to the weakening in the USD and the growing anticipation of interest rates cuts in 2024.

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Chart Constituents

Notes

- *Currency: AUD.*
- *UH: Unhedged.*
- *H: Hedged.*
- *Net Index: Total Return (Net Dividends Reinvested).*
- *Total Return: Total Return Index with Gross Dividends.*
- *Where a lag exists, the performance period start and end dates are shifted accordingly.*

Asset class	Benchmark	Data type
Australian Shares	S&P/ASX 300	Total Return
Australian Small Caps	S&P/ASX Small Ordinaries	Total Return
Overseas Shares (UH)	MSCI World ex Australia	Net Index
Overseas Shares (H)	MSCI World ex Australia 100% Hedged	Net Index
Overseas Small Caps (UH)	MSCI World Small Cap	Total Return
Emerging Markets (UH)	MSCI Emerging Markets	Net Index
Direct Property (one month lag)	MSCI/Mercer Australia Core Wholesale Monthly PFI	NAV Post Fee
Australian REITs	S&P/ASX 300: Industry Group: A-REIT	Total Return
Global REITs (H)	FTSE EPRA/NAREIT Developed Hedged	Total Return
Global Listed Infrastructure (H)	FTSE Global Core Infrastructure 50/50 Hedged	Total Return
Global Credit (H)	Bloomberg Global Credit	Hedged Return
Emerging Market Debt (UH)	JP Morgan GBI EM Global Diversified Composite	Total Return
Australian Government Bonds	Bloomberg AusBond Treasury 0+ year	Total Return
Overseas Government Bonds (H)	FTSE WGBI Non Australia	Hedged Return
Cash	Bloomberg AusBond Bank Bill	Total Return

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