Global Outlook

January 2024

A Pivotal Year

Global inflation has peaked, but the last mile to target will be the most arduous and still requires a long period of below trend growth. Be wary of calls for early and aggressive interest rate cuts.

BEVAN GRAHAM

Outlook for New Zealand Equities

The difficult environment New Zealand equities are having to contend with is unlikely to improve in near term, but as cost inflation progressively normalises during 2024, the downgrade cycle could slowly give way to margin recovery and an improved earnings outlook.

PAUL TURNBULL

Implications For Investors

In 2024 we expect a similar year to 2023 where ultimately strong market returns took patience and tolerance for elevated volatility, but with more moderate equity returns and wide variations between markets.

GREG FLEMING

SALT

Funds Management

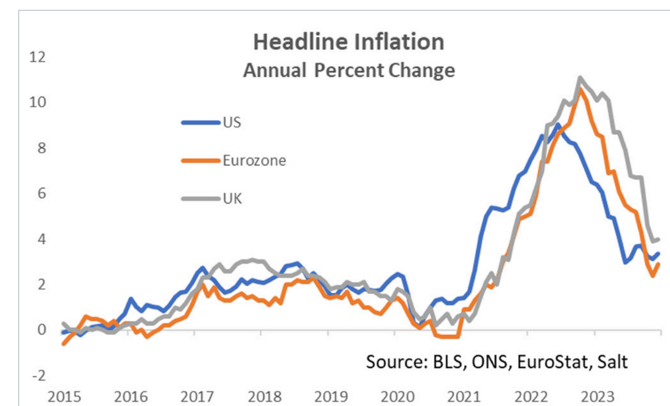
A Pivotal Year

Global inflation has peaked, but the last mile to target will, like running a marathon, be the most arduous. Furthermore, it will take a considerable period of below trend growth to get there. Most importantly however, central banks will only start cutting interest rates when they believe the broad range of conditions are in place for a sustained return to target inflation.

We believe those conditions will be in place in most developed market (DM) economies at some point this year, most likely in the second half. That being the case, we recommend being wary of calls for early and aggressive interest rate cuts, particularly in the US, where we believe markets got a bit ahead of themselves in late 2023.

The last mile will be arduous

Headline inflation fell rapidly in the early stages of the disinflation as Covid-related supply chain bottlenecks eased and commodity prices, particularly for energy, retreated. Peak inflation rates of near double digits in some countries quickly moved to mid-to-low single digit in 2023.



But through 2023 we also saw the emergence of increasingly problematic sticky core services inflation. This is the bit of the inflation equation that has had us firmly in the "persistent" inflation camp as opposed to "transitory" right from the start of that interminable debate in 2022.

At the very heart of that more persistent part of inflation has been resilient and tight labour markets. Low unemployment rates and high wage inflation were always going to prove persistent without a meaningful tightening in monetary conditions that brought better balance to labour markets.

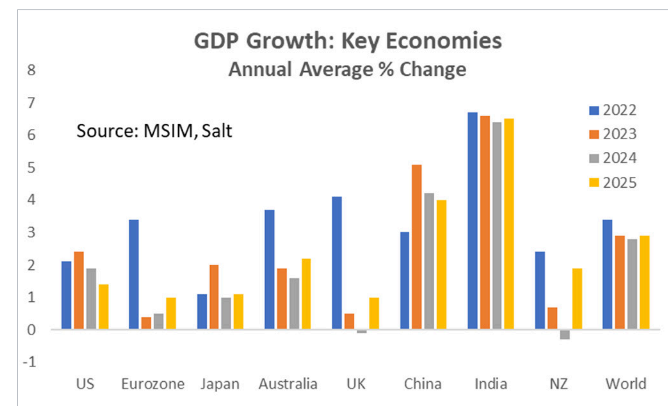
Progress has been made in general across most DM's, but labour markets are still too tight for central banks to believe that conditions are right for a sustained return to 2% inflation. That will still take some time with monetary policy needing to continue to exert downward pressure on the cycle.

Subdued growth ahead

We see monetary policy on hold in the key developed markets (excluding Japan) in the first half of the year. That will see tight monetary policy continuing to work its way through respective economies.

In the United States, the soft-landing scenario still appears intact, due in large part to continued strength in consumer spending, itself borne of the resilient labour market CPI inflation will likely continue to recede from here, boosting real incomes, but with nominal interest rates on hold, real interest rates will continue to tighten.

Residential investment is expected to be constrained by poor affordability and business investment will likely only turn positive as interest rate start to fall. On balance the economy is expected to continue to decelerate in 2024 and 2025. After estimated growth of 2.4% in 2023, expect 1.9% in 2024 and 1.4% in 2025.



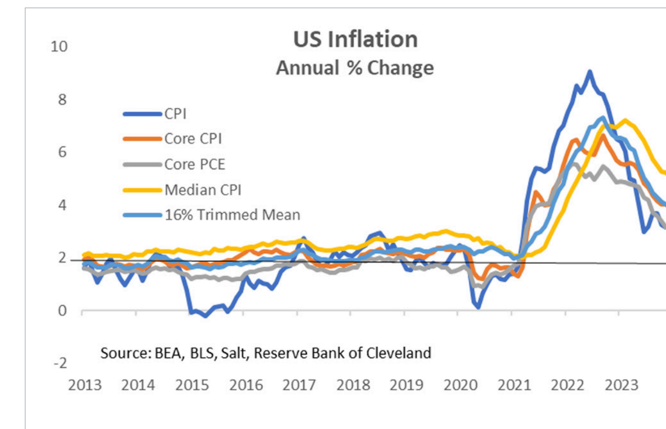
It's tougher going in Europe. Consumption and investment were stagnant through 2023, and that's before monetary policy has its most restrictive impact in the first half of 2024. Momentum from global trade will also be at its weakest through early 2024. On the upside, the resilient labour market and rising real incomes will start to lift consumer spending as the year progresses. Following estimated GDP growth of 0.4% y/y in 2023, expect 0.5% in 2024 and 1.0% in 2025.

Further disinflation

In 2024, we expect inflation to continue to fall in the US and Europe. This will allow the commencement of easing cycles against the backdrop of soft economic activity.

The US disinflationary cycle has made good progress but still has further to go. However, the easier wins of 2023 are now behind us and are being replaced by a more challenging set of dynamics as the finish line approaches.

The spotlight will remain on core service inflation. Further progress on this requires a slowing job market and a continued easing in wage inflation. At the same time, we worry that the recent deflationary trend in goods prices may have run its course to be now replaced by higher contributions compared with year ago levels.

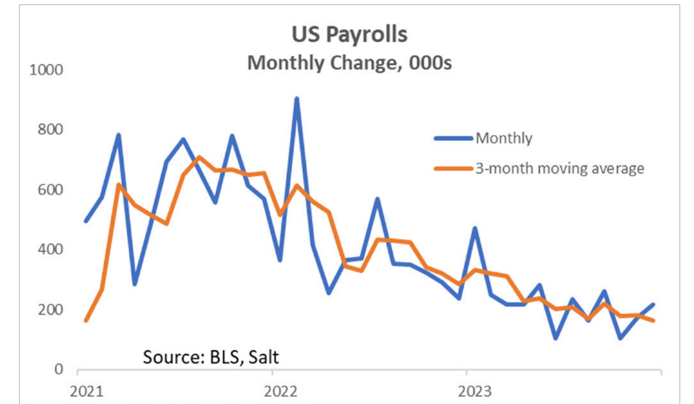


In the euro area, the key components of inflation are now off their peaks and some measures have started to surprise on the downside. Market moves to price in earlier rate cuts on the back of this has been met with a stern rebuke from members of the ECB's Governing Council in public remarks.

Looking ahead we expect further falls in core inflation, aided by the underwhelming growth outlook and slowing nominal wage growth. The growth outlook across the region presents a greater risk of undershooting the central bank's inflation target than in the US, so rate cuts here, while not necessarily coming before the Fed, may be more aggressive.

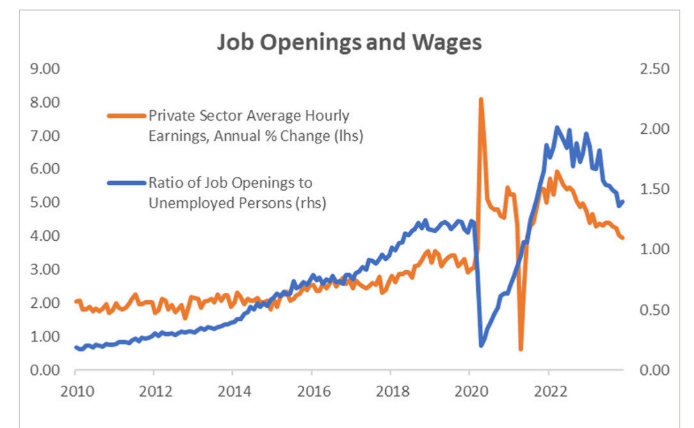
The US labour market – too tight for early cuts

Watching labour market data is going to be critical to the inflation and monetary policy outlook in the months ahead. However, sometimes it's hard to get a clear picture of the state of the labour market from the monthly data dump from the US Bureau of Labor Statistics. Across both the establishment and household surveys, there's usually at least one piece of data for every monetary policy view. The December data released in early January was one of those very results.



The reality is, however, that the US labour market is still too tight to contemplate interest rate cuts anytime soon:

- the 3-month moving average of monthly payroll gains has slowed to 165k, however it remains higher than the replacement rate (the level of payrolls growth below which the unemployment rate will start to rise) of 90k;
- the unemployment rate, currently at 3.7% in December, has been stuck in a 3.5% to 3.8% range since May last year, still well below the Fed's estimate of the long run rate of 4.5%; and
- wage growth appears stuck at around 4%, still higher than the level of around 2.5% to 3.0% the Fed believes would be consistent with 2% inflation.
- it's helpful to look at a broader range of indicators. One of our favourites is the ratio of job openings to unemployed people.



Note that in the early days of this chart, the ratio is below 1.0 (i.e. there are more unemployed people than there are job openings) and wage growth is well under control at around 2% per annum. That's around (probably below when you add in some productivity) the level the Fed will think is consistent with target inflation. As the ratio moves above 1.0 (i.e. more job openings than unemployed people), wage growth starts to accelerate. Indeed, recall the Fed started a rate hiking cycle that started at the end of 2015 and continued until the end of 2018 when they started easing again.

Ignore the Covid years and fast forward to 2022. Job openings surged after Covid, as did wage growth. The

ratio peaked at 2.0 jobs for every unemployed person in March 2022. It's no coincidence (in our view) the annual rate of private sector average hourly earnings growth peaked at the same time at 5.9%.

Right now, at 1.4 the ratio is still too high, as is wage growth at 4%. The Fed needs to believe that it will fall back below 1.0 before they are comfortable of achieving sustained 2% inflation. That's still going to take a while yet.

Pivoting to cuts

Most DM central banks have signalled that interest rates have more than likely peaked, and that they will keep rates at that peak until they are convinced that inflation is converging to target.

We expect the Fed to hold interest rates elevated until it sees inflation approaching target along with a broader set of conditions in place that lead then to believe that inflation will remain at target on a sustained basis.

The Fed will want to see a few months of weaker growth, inflation and labour market data before they cut. The earliest we see them cutting the fed funds rate is June. Furthermore, we expect them to be cautious in their approach to relaxing conditions. Assuming a start in June, we expect four 25bp cuts this year, followed by more in 2025.

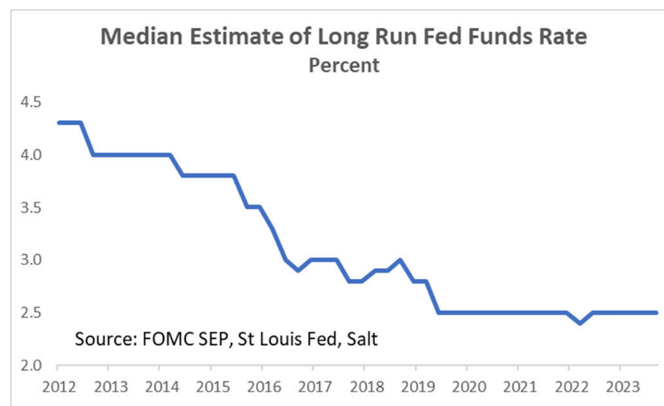
We expect the ECB to start cutting around the same time as the Fed. The ECB has been more focussed on headline inflation, but the weaker euro area activity data should lead them to lower their inflation forecasts, leading to a reduction of interest rates. The weaker growth environment than the US, could see the ECB cutting rates both earlier and more aggressively than the Fed, even considering the lower starting point.

How low can they go?

You will have noted our lack of commitment thus far in signalling what level monetary policy interest rates may be cut to in 2025.

Neutral interest rates do move. In recent times (since the Global Financial Crisis), the traffic has been generally one way. In the United States, you only have to go back to 2012 to find the Fed believed the neutral monetary policy rate was 4.25%. Today, the median long-term interest rate "dot" is at 2.5%.

Regular readers of our research will know that there are a host of factors that lead us to believe that neutral intertest rates are now higher than they were in that period after the GFC but before the pandemic. These include easier fiscal policy, higher debt levels, deglobalisation and ageing populations in a world of moribund productivity



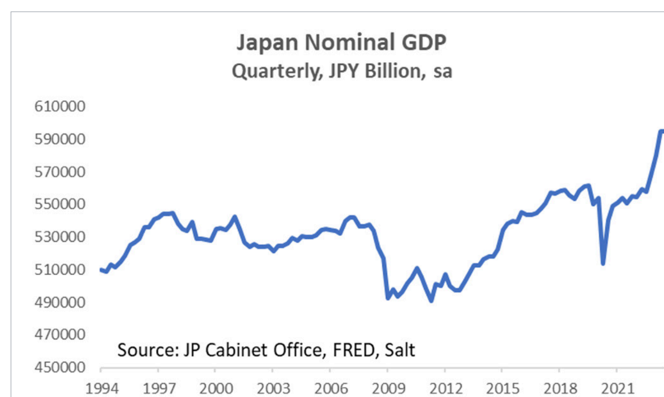
It's also possible to imagine a scenario in which central banks don't cut interest rates at all. If the soft-landing plays out in the US and GDP growth settles at around 1.5-2.0%, the unemployment rate rises to 4.0-4.5% and disinflation hits the wall at 2.5%, why would the Fed cut interest rates at all?

Only time will tell how far rates can be cut in the downward part of this interest rate cycle. For now, we urge caution in assuming the "old normal" still prevails.

Japan is still a special case, but now in a good way

Our commentary thus far has focussed on the United States and Europe. Japan is continuing its long run of being a special case, even as other major central banks pivot to cutting.

Japanese nominal GDP is estimated to have risen by around 5%+ last year. Now that's a sentence I never thought I'd write! Furthermore, we believe that at least part of that result is due to structural forces that may well persist, allowing Japan to escape its long period of low GDP growth and deflation.



Importantly, we think nominal GDP will continue to be supported by solid wage growth leading to both sustained domestic inflation and solid domestic demand and real GDP growth. Furthermore, sustained nominal GDP growth is good for corporate earnings and fiscal sustainability.

Key in this view of renewed strength in domestic demand is another strong shunto (spring wage negotiations) in

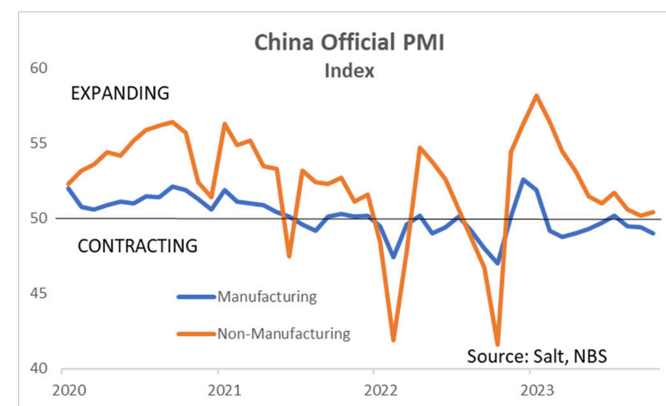
2024. Fiscal initiatives including the extended energy subsidies and the temporary tax cuts will also support domestic spending in the near term. We also expect private capital growth to remain strong as demographic pressures force businesses to adopt labour saving technology.

We expect inflation to settle at higher level than historically, allowing the Bank of Japan to exit both its Yield Curve Control (YCC) and Negative Interest Rate (NIRP) policies in the first few months of 2024 and could come as early as this month. YCC went through various "tweaks" from December 2022, with the last change in October last year being a shift in the upper limit of 1.0% for 10-Year Japanese Government Bond yields to a "reference" rather than a hard limit.

However, after the initial "normalisation" of monetary policy, it's a higher hurdle to tighten policy further. That will require inflation to be sustained at about 2% and for inflation expectations to become anchored at 2%. That will still take time.

More work to do in China

China's Covid reopening bounce in early 2023 proved short-lived and economic momentum slowed noticeably at the year progressed. This slowdown was most noticeable in the consumer sector and in real estate.



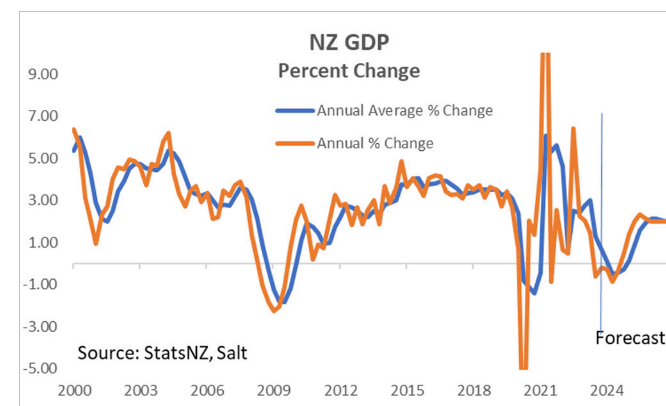
Authorities implemented a range of measures over the last few months to attempt to support activity. These measures include interest rate reductions across a range of facilities, and a cut to the Reserve Requirement Ratio (RRR) in September. These measures have generally been reactive and of insufficient magnitude to offset the impact of the deleveraging required in real estate and Local Government Financing Vehicles (LGFV).

However, they did generate some improvement in activity data the third quarter of the year, though December quarter GDP was a modest disappointment, suggesting the road to stabilisation will remain bumpy.

Much of what ails the Chinese economy is structural in nature including debt issues, demographic challenges, and geo-political tensions. These all point to weaker growth prospects in the period ahead. That suggests more policy easing is likely, the risk being it remain reactive and too timid.

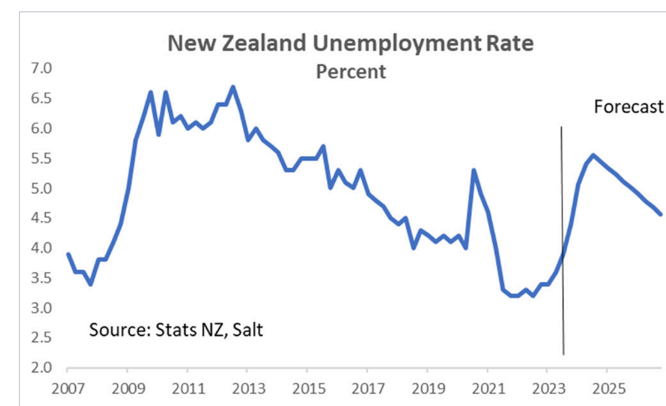
New Zealand: first to hike, last to cut?

Given the long list of negatives for the economy, we have been surprised by the resilience in some of the activity data. That was "put right" with the release of Q3 GDP data showing a contraction in activity of -0.3% q/q (RBNZ +0.3%) and significant downward revisions to prior data.



We believe the first half of 2024 will be the toughest period yet for the economy. Ongoing pass-through of higher interest rates, slowing employment growth, weaker business investment, and softer global growth all paint a picture of broad-based weakness in activity in the period ahead. Migration-led population growth, which at 2.7% in the year to September is the strongest in decades, is taking the roughest edges off the recession, but not eliminating it entirely.

Conditions in the labour market are becoming "less tight". Employment growth is slowing to zero, but continued growth in labour supply is expected to see the unemployment rate hit 5.6% this year.



Headline inflation is surprising on the downside, but most of the surprise is in tradeables inflation, not in domestically generated inflation pressures which are the focus for the RBNZ. The downward GDP revisions are something of a game-changer for monetary policy, but

only up to a point. While it supports our view that the RBNZ has done enough, it doesn't of itself bring forward interest rate cuts. That will require downside surprises in non-tradeable inflation, and that remains to be seen.

The bottom line is we believe the RBNZ has done enough tightening, but we don't expect the first cut in interest rates to come until November this year.

Politics and Geo-politics

Global markets are continuing to be confronted with a complex array of political and geopolitical risks that have the potential to shape economic landscapes and financial conditions.

The most prominent of these concerns is the evolving nature of super-power competition, primarily between the United States and China. As these two economic giants vie for dominance in technology, trade, and influence, tensions could escalate, introducing uncertainties that reverberate across markets.

Regional conflicts also contribute to geopolitical risks, with hotspots like the Middle East and Eastern Europe posing challenges to stability. Ongoing disputes, the risk of escalation, and the potential for new conflicts may disrupt energy supplies, impacting commodity prices and market sentiment, as we are currently seeing in the Red Sea.

Environmental concerns further compound geopolitical risks, as nations grapple with the need for collective action on climate change. Disagreements over climate policies may strain diplomatic relations and impact industries, particularly those reliant on fossil fuels.

The interplay between politics and technology introduces another layer of risk, with issues such as cyber threats and data privacy becoming increasingly significant. Governments' regulatory approaches to emerging technologies could influence market dynamics, creating both opportunities and challenges for investors.

The rise of populist movements in various parts of the world introduces domestic political uncertainties, as leaders with divergent ideologies reshape policies and priorities. As we write, Donald Trump has just won the Iowa Republican Caucus and appears odds on favourite to retake the White House.

Can Trump win again?

Absolutely. The problems that led to his victory in 2016 have not gone away. Poverty and economic and political disenfranchisement are alive and well in America. The only pathway to ending populist political movements is to close inequality gaps, and that's not happening in America, or anywhere else for that matter.

There is still hope for President Biden. A soft economic landing, lower inflation and potentially lower interest rates by November may yet see him prevail.

Furthermore, it is hard to judge the depth of core support for Trump. Yes, he won the Iowa Caucus by a handsome margin, but only 80,000 people voted. And it's worth remembering that while he won the presidency in 2016, Mrs. Clinton won the popular vote.

My primary concern of a second Trump White House is his complete disregard for national and international institutions. This poses significant risks when tensions are already high and comes a time when we have never had better reason to act collectively on issues such as climate change.

Domestically, his disdain for established norms strained the delicate balance of checks and balances, undermining the strength of democratic institutions.

Internationally, Trump's scepticism toward alliances and agreements weakened global cooperation, creating geopolitical uncertainties. Withdrawals from key international accords, like the Paris Agreement, risked environmental progress.

Furthermore, his unconventional approach to diplomacy strained relationships with traditional allies, impacting collective efforts on issues like trade and security. The erosion of institutional respect and cooperation during his tenure underscored potential long-term consequences for both domestic stability and global collaboration.

Bevan Graham

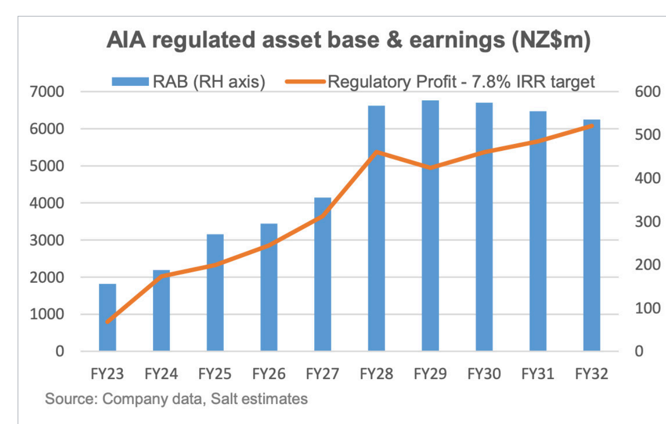
Outlook for New Zealand Equities

It was a weak start to the December quarter with NZ Equities declining -4.8% in the month of October to a 16-month low as rising bond yields and perceived negative earnings risk continued to undermine the valuation metrics of global markets. However, investor sentiment began to shift from early November as inflation data buoyed expectations for an end to central bank tightening and presented a positive catalyst for equities. The NZ Equity market delivered a solid return of +4.2% in the 3-months to December 2023, although once again lagged broader market performance, with the MSCI World Index posting a +11.4% return in the period. The gain in NZ equities followed a -5.2% negative return in the prior quarter, with returns moving to +2.6% on a 12-month rolling basis.

The December 2023 quarter was notable for the performance of small-cap constituents, with positive returns led by new additions to the NZX50, Gentrack (GTK, +38.2%) and Turners Automotive Group (TRA, +24.5%), with strong outperformance also coming from Fonterra Shareholders Fund (FSF, +15.6%), Scales Corporation (SCL, +14.6%) and Vista Group (VGL, +14.6%). Conversely, Synlait Milk (SML, -33.6%) underperformed in the lead up to its removal from the NZX50, as did retailers Hallenstein Glasson (HLG, -10.7%) and Kathmandu (KMD, -10.3%) following weak trading updates during the period.

Bond rate sensitive stocks, including property, infrastructure and long-duration growth, generally pushed higher in the December quarter. Top property sector performers included Stride (SPG, +15.0%), Precinct (PCT, +10.2%) and Goodman Property Trust (GMT, +8.5%), while large cap growth names Auckland Airport (AIA, +11.3%), Fisher & Paykel Healthcare (FPH, +10.2%) and Mainfreight (MFT, +7.6%) were boosted by both the bond rate tail wind and stock specific news.

Negative risk attached to AIA's longer-term regulated return profile was removed in mid-December following the Commerce Commission publishing its final decision on its 7-yearly review of the input methodologies for regulated airport assets. The key change was a reversal of a June 2023 draft decision to lower airport betas which would have driven a lower allowed return for AIA's regulated asset base. In somewhat of a surprise to the market, the Commerce Commission decided instead to lift airport betas, thereby lifting the earnings path for AIA from FY28. The importance of this decision is underlined by the significant aeronautical capital investment program that AIA has committed to over the next decade, with the Commission's decision ensuring that AIA will continue to earn an excess return on that capital investment. While positive for our valuation, we continue to view the current share price as expensive.



FPH delivered a 1H24 result in November that was modestly ahead of market expectations and alleviated concerns around shorter-term earnings risk. Stronger OSA mask growth post successful new product launches and improving gross margins were key positive features of the result. We continue to expect a gradual recovery of profit margins back to pre-Covid levels through a combination of contract renewal cost recovery and volume driven positive operating leverage. In addition to the result, investor concerns around the threat of GLP1 weight loss drugs to FPH's OSA addressable market appear to be dissipating, with the majority of industry experts that we engaged with stating the case for only a modest to moderate medium to long-term impact. We believe that FPH continues to offer a high-quality exposure to compounding earnings growth and strong excess return on capital.

MFT's share price fluctuated through the quarter, with a drop of -12.2% in October more than offset by a spike of +20.3% across the balance of the period following the release of its 1H24 result in early November. Pre-result expectations for a material earnings downgrade did not materialise, with evidence that Air & Ocean margins were stabilising at higher levels than some had feared and management commentary, while still cautious, surprising to the upside. We believe that weak consumer activity is likely to extend well into CY24, possibly bottoming towards the middle of the year, and therefore MFT will need to continue to navigate through a challenging macro backdrop at least until part way through FY25. However, with reduced negative tail risk attached to the post-Covid rebasing of earnings, the market's focus looks to have shifted back to MFT's global network growth option.

Large and mid-cap stocks to underperform in the December quarter included Heartland Bank (HGH, -16.9%), Air New Zealand (AIR, -13.0%), Ryman Healthcare (RYM, -6.5%) and Sky City Entertainment (SKC, -5.7%). Whereas ongoing balance sheet concerns and elevated inventory levels presented the key headwind to RYM's performance, profit warnings were front-of-mind for investors in HGH, AIR and SKC in the month of December.

HGH downgraded FY24 earnings guidance by -20% in mid-December, citing operational headwinds, higher costs relating to the recent acquisition of Challenger Bank and additional provisioning. Weak operational performance can be directly linked back to the weak consumer environment evident in New Zealand. HGH's conservative policy towards hiking lending rates, particularly in its Reserve Mortgage and Livestock divisions, and increased competition in the deposit market, saw downward pressure on net interest margins and consequently the shorter-term earnings outlook.

AIR's earnings guidance downgrade did not come as a surprise to us, with management discussion around cost inflation pointing to undue optimism in consensus margin estimates and recent monthly operational updates outlining ongoing deterioration in yields across key markets. Subsequent consensus downgrades were material, and our expectation is that risk bias remains negative across the balance of FY24. The one major swing factor, at least for short-term earnings, is the volatility in jet fuel pricing. However, in our opinion, the airline industry is unlikely to have deviated far from the boom-bust earnings cycles that dominated investor sentiment towards the sector in the pre-Covid era.

Our expectation is that the difficult macro backdrop that New Zealand equities are currently having to contend with is unlikely to improve in the short-term, with weak activity levels to continue for at least the next 1-2 quarters. However, cost inflation should progressively normalise across CY24 and, for companies that can continue to deliver positive price leadership, we believe that the downgrade cycle could slowly give way to margin recovery and an improved earnings outlook. The risk to this scenario would be a further step down in consumer spending that exacerbates the surplus in manufacturing and service capacity and further fuels the downgrade cycle through negative scale leverage and lower pricing.

Overall, our base-case scenario is unchanged, with a trough in earnings for New Zealand cyclicals expected around mid-CY24, followed by a gradual resumption of earnings growth. Based on previous cycles, we expect that markets will continue to price these downgrades (and eventually upgrades) in ahead of actual consensus revisions. We look for pricing power, market share growth option value and sustainable competitive advantage that will support excess return on capital generation when setting conviction overweight positions. Against the current challenging economic backdrop, we continue to favour reasonably priced defensive and secular growth exposures, however we also have a preference towards higher-quality cyclical names where we believe downgrade momentum is beginning to turn and that offer deep relative value on mid-cycle earnings forecasts.

Paul Turnbull

Implications for Investors

As the new year gets underway, investors are stressing the positive factors in the complex mix of market influences which have prevailed since the Covid disruptions initiated a new phase of heightened uncertainty and volatility. The US S&P 500 Index finally reached a new all-time high in mid-January 2024, closing above the elusive 4,800 index level for the first time since January 2022. The intervening two years had seen a confidence-sapping equity bear market, which bottomed out in October 2022 with a 27% peak-to-trough decline. Since the bottom was reached, the index has rallied an impressive 38%, as US corporate earnings showed resilience and investors were willing to look through weaker quarters in anticipation of a solid profits rebound expected by analysts for 2024.

The "tug-of-war" in markets between the more constructive economic news flows that allowed international equities and bonds to both record above-average annual gains in 2023, and the negative ones, which have led to wide swings in bond interest rates, and weak returns from energy and commodities sectors (gold excepted) continued through to the end of last year. However, because of the elevated impact of central bank monetary policy at present, given the campaign to bring inflation back toward target bands, the year closed on a note of optimism. Perceptions that the next move in key international interest rates will be downwards became dominant, and the debate now centers on the timing and the scale of future interest rate cuts from the key global central banks.

Internationally, regions have experienced significant variation in their susceptibility to the continuing downward weight of high interest rates on economic activity. Europe and the United Kingdom were skirting recession throughout last year, as was New Zealand. The United States, Australia and Japan have been more resilient – though in Japan's case, the economy has not yet needed to adjust to a substantial lift in interest rates.

However, the impact of slower growth in most markets on investment returns has been quite varied. The starting point for gains in many asset markets was favourable, after the price weakness of 2022, which allowed investors to progressively build up their holdings in fundamentally-sound securities that infrequently trade at low valuations. This was true in the Technology, Consumer Discretionary and even in the Real Estate sector, which saw very pessimistic re-pricings during the Bear Market, but which were all leading sources of returns in later 2023.

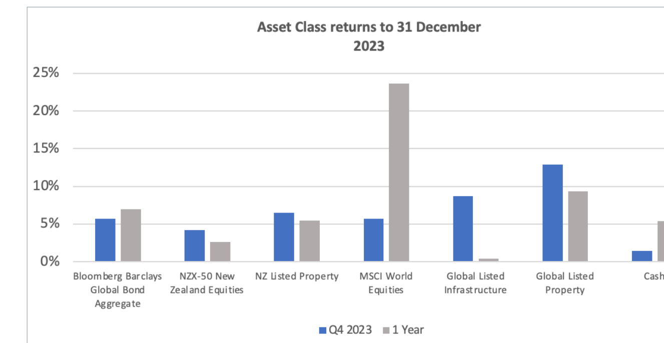
Central bank 'pipers' playing a slightly brighter tune

The interest rate-sensitivity of industry sectors that discount their earnings further into the future, as well as the unprecedented level of the global indebtedness burden, have made central banks in general, and the U.S. Federal Reserve in particular, into the "pipers that call the tune" on asset market sentiment. As investors adjust their expected implementation timeframe for the coming easings in monetary policy around the world, minute attention is being paid to public statements by central bankers. Such influential speakers are broadly conveying that investors should not rush to anticipate imminent easings, while still signalling that interest rate cuts of a moderate magnitude do indeed lie ahead. They walk a fine line between allowing markets to over-loosen financial conditions, and sparking a negative feedback loop whereby asset prices could dip downward again and generate instability.

Although there has been a moderation in the euphoric expectations for rapid rate cuts as 2024 begins, the key thrust of central bank messaging has been that inflationary pressures are indeed gradually fading. However, the complication is that a lack of new inflationary impetus does not automatically guarantee sharp interest rate reductions, and certainly not before both the existing price risks and emerging geopolitical risks are deemed sufficiently manageable.

The upshot for markets of the current inflection point between a period of restrictive monetary policy and a neutral period, is that benign returns can still be expected, unless a sentiment swing on the interest rate outlook or on consumers' optimism and willingness to spend disrupts the central scenario.

Fourth Quarter 2023 returns exhibit cautious optimism



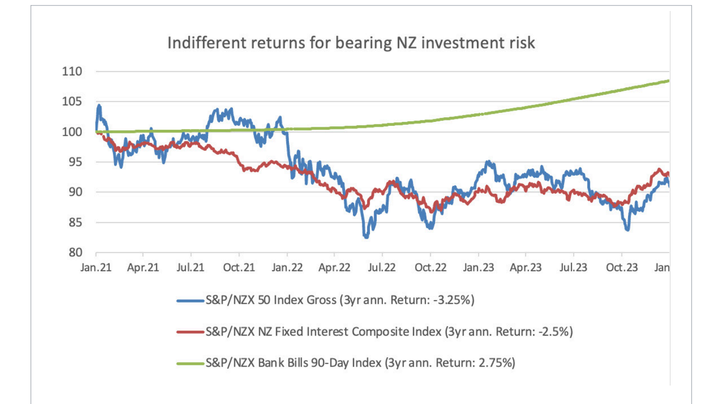
Source: S&P Global Indices, Salt

As the chart above shows, major asset classes generated acceptable returns for 2023 as a whole, despite the regular and disorienting shifts in sentiment and confidence that were characteristic of the year. global bonds, equities and property securities were leading contributors to portfolio returns, whilst global infrastructure – having played a valuable defensive role in the 2022 bear market – was a clear laggard for the 2023 calendar year, in which interest rates provided very little support until late in Q4.

Domestic equities were generally overshadowed by the sluggish local economy and uncertainty factors explored in earlier sections of this "Global Outlook" report. Among the purely New Zealand asset classes, it was difficult to secure a higher return than from simply holding NZD Cash or term deposits. The uninspiring 2.6% full-year return from the NZX 50 Index proved to be less than half the return for the year available from simply investing in NZ 90-day bills (5.3% 2023 return.) NZ equities also substantially underperformed their Australian counterparts, with the ASX 200 Index recording a respectable 12.4% 2023 gain.

This outcome for NZ shares was in line with our expectations, and for that reason our **Salt Sustainable Growth Fund** ran a consistently underweight strategy to domestic equities all year. The dynamic positioning in that fund in tilting away from NZ shares and in favour of Global equities, global property and infrastructure stocks was crucial in helping the Growth Fund achieve a 10.2% gross 2023 return, which for the year means that the fund's long-term performance objective of protecting investors purchasing power by achieving a 5% return above the CPI inflation rate was back on track – even during a high inflation period.

Non-Cash NZ assets have tended to drag on portfolio returns since 2021



Source: S&P Global Indices, data to 19 Jan. 2024

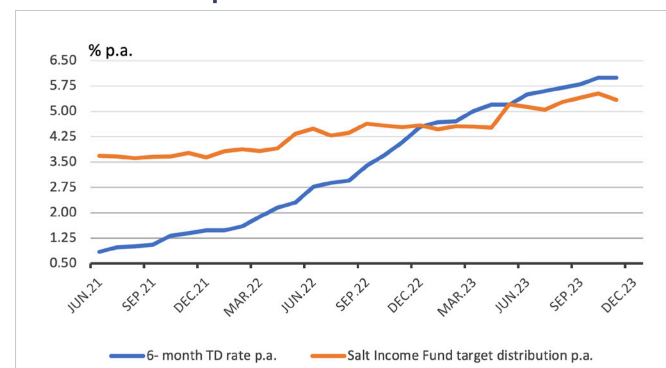
Might (some) New Zealand assets catch up this year?

Looking forward into 2024, though, after two years of New Zealand assets offering little reward for the risk taken, forces getting underway can potentially set up the preconditions for better domestic equity returns, which could manifest in the middle- and later parts of this year. In the meantime, though, there are more compelling reasons to seek out more of the higher-quality international asset exposures which we favoured in 2023. Other countries are more advanced in their inflation reduction programs than New Zealand, and the specific defensive utility / financial / health care biases in the domestic equity market do not yet recommend any elevated home market bias in portfolios – with one exception: Income-focused, medium investment horizon asset allocations. For these, the attractive forward yields of between 5 and 7% on average still available from NZ's listed Real Estate and Dividend-focused equities do play a valuable role in diversifying the sources of total portfolio returns, beyond simply capital appreciation.

The advantages of such allocations are presently masked by high Term Deposit rates, but in our view, offered rates have peaked in New Zealand, and banks will increasingly begin trimming rates as 2024 progresses, whilst our own Sustainable Income Fund should be able to maintain a stable distribution level. The reason for that is that the Income fund has a diverse international portfolio of yield-carrying securities, and thus is not excessively exposed to the dividend and bond coupon levels prevailing in the comparatively concentrated Australasian markets. Although global bond yields have moved down from their peaks, there is still a very attractive risk-return value proposition in the international fixed income investment universe. In particular, the non-Sovereign bond markets have not yet priced in the somewhat better economic outlook as well as down-shift in yields seen in Government, and selected credit spreads can potentially narrow further.

Non-benchmarked allocations that are not hamstrung by the weightings in the Bloomberg Global Aggregate will continue to provide valuable opportunities to add value.

Salt Sustainable Income Fund's target distribution vs 6-month Term Deposit



Source: Salt Funds Management, RBNZ

Global equity markets are happier, but also pricier

The period since the massive, counter-pandemic stimulus liquidity began being drained from the global economy has led to more variation in equity market performances and a de-synchronising of returns, when compared to the notorious "everything rallies" which ran from mid-2020 through to the top of the recovery Bull market at the end of 2021. All the same, the strength seen in almost all global markets in November and December 2023 has inevitably pushed some major indices up once again into the more expensive end of their historical ranges.

Geopolitics matters: China & Hong Kong went against bullish trend in 2023-24

	Current		Last Month	2023
Region	P/E	P/B	Total Return (USD) %	
MSCI ACWI	20.1	2.9	4.8	22.8
S&P 500	21.9	4.5	4.5	26.3
MSCI Europe	14.3	2.0	5.0	20.7
UK FTSE 100	10.2	1.7	5.0	13.6
Germany DAX	12.5	1.4	5.0	24.3
France CAC 40	12.5	1.8	5.0	24.1
Japan Topix	15.8	1.3	5.0	19.0
Korea KOSPI	17.5	0.9	5.8	16.9
Hang Seng	9.4	1.0	0.2	-10.6
Taiwan	19.2	2.4	5.5	31.3
Brazil Bovespa	9.7	1.6	6.8	33.1
Mexico	15.0	2.2	9.2	40.9
S. Africa	11.6	1.6	4.8	1.8
China	11.8	1.2	-1.3	-3.9
India	25.2	3.9	8.1	19.6

Source: MSCI, MSIM (Last Month = December 2023, trailing P/E ratios shading relative to history)

While the U.S. dominated many headlines, the equity rebound has been far from limited to the world's largest market. European shares, for instance, were able to disregard sluggish EU market economic activity, as well as persistently weakening Chinese activity, which normally bodes ill for European exporters. Investors preferred to focus on the prospects for lower interest rates from mid-2024 onwards, allowing the broad EuroStoxx 600 Index to gain 12.5% for the year (in EUR terms.) The persistent global investor preference for large capitalisation companies was clearly evident in Europe, as the rally in the Stoxx 50 Index, tracking Europe's largest listed enterprises, was stronger still, at +19% for the year. The importance of geopolitics as an investment risk is underlined by the continuing abysmal performance of the Chinese and Hong Kong stock markets, where political interference in businesses appears to have reached a point of repulsion for many investors.

Emerging Markets and Europe remain historically cheap

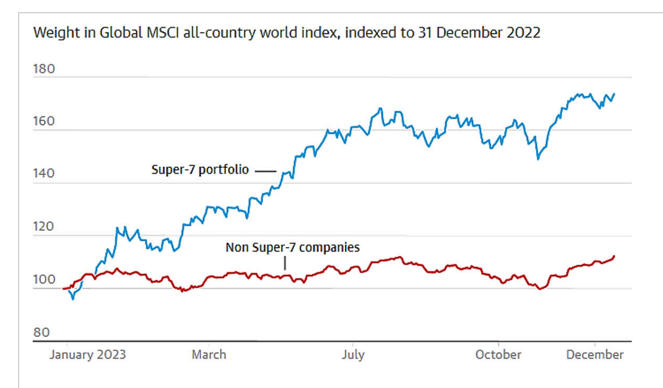
This point dramatises the proverbial "value trap" for investors. China, and by extension several other Emerging Markets, are indeed trading at low valuations presently. However, these comparatively low multiples are not without valid reasons. Political, demographic, diplomatic, sectoral and environmental influences are all very different in China, India, Taiwan, South Korea, Brazil, Turkey. Similarly, the European Union has very distinctive societal and governance qualities, as does Japan. However, given that there are competing, transparent and widely-appreciated opportunities elsewhere, some enterprises in these traditional destinations for international equity diversification are finding it more difficult to attract the capital inflows that in prior decades often accompanied a period of "excessive" U.S. dominance of portfolio returns. Higher-risk tolerant capital flows now have a very wide range of more (or less) speculative alternatives to simply seeking out an underappreciated jurisdiction and buying assets therein. This means that while the US markets in the last decade have built up a persistent P/E valuation premium over traditional alternatives, that fact does not by itself imply that a period of "catch-up" is more probable for other regions. Contrarily, were the U.S. to develop in a political, diplomatic or environmental direction that threatened investor confidence and transparency, it may eventually catalyse a closing-up particularly of the European valuation gap to US equities (as in 2001-02.)

Source: MSIM, DataStream data as at 31 December 2023

To the Largest, go the Spoils?

As well as such stark geographical differentiations, performance divergence in 2023 between Large Cap. and Small Cap. securities was a clear characteristic of recent years' preferences by investors for stable, "established winners" over the trickier domain of identifying unjustly mispriced or lesser-known listed enterprises. Thus, the 2023 full year delivered a 9% total return performance gap between global giants (MSCI ACWI Large Cap; +21.2%) and the Small Cap minnows (+12%.) For the US, of course, the gap was even wider: US Large Caps gained 27% in total return for 2023, compared with 14% for the US Small Caps in the MSCI USA Index universe.

The template for recent years' marked outperformance by the highly recognisable global brands operating within some segment of the Technology spectrum, remains the United States. Whilst Large Cap. Technology growth companies experienced a very weak year in 2022, their resurgence throughout the 2023 market recovery was undeniably eye-catching. It is frequently reported that the "Magnificent- or "Super-7" U.S tech aristocracy comprising Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla were responsible for 60% of the total S&P 500 Index' gains in 2023. However, equally remarkable is the snowballing weights of those seven companies within the main international equity indices. The Super-7 moved up toward a 20% weighting in the MSCI World Index last year, and to a 28% weighting within the S&P 500.



Source: Schroders, LSEG DataStream

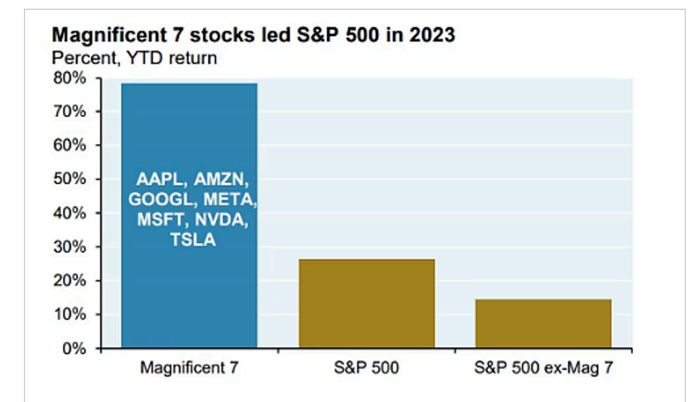
The basic attraction of these companies, beyond their very high media profiles which bring them regularly to the attention of non-professional investors, are summarised below:

Operational performance: Some mega-cap technology stocks have among the world's strongest business models, with products used by millions and even billions of consumers. They have established businesses, deep financial resources and can continue to grow. They tend to have pricing power, customer loyalty, and highly credible innovation pipelines. The high cash reserves of some are not seen as inefficient, or available for use to pay high dividends, but are positively viewed as providing buffering in difficult economic periods.

Stock performance: These stocks' performance during periods of uncertainty is a draw, although strong periods of valuation gain can be followed by sharp phases of market underperformance, as occurred in 2022. However, the Super-7 all pushed higher in 2023, building on their more attractive late-2022 valuation levels, and increasingly due to their association with Artificial Intelligence (AI.)

AI prospects: These companies stand to be beneficiaries of AI technology, whether they provide services based on some application of Artificial Intelligence tech, or in the case of NVIDIA, build the microchips that enable AI enhancements to existing and new electronic devices in a wide range of industries.

These three arguments are easy to grasp and widespread among investing pundits. However, they over-simplify the merits and risks within a technology-fixated investment paradigm. They also imply that Super-7 stocks possess fixed qualities that underwrite their repeating prior strong returns ad infinitum. Our view is well: some do, and others don't. There may potentially still be seven market leaders over the next year, but they could very



well be a modified list of megacaps.

Source: JP Morgan Asset Management, Bloomberg

Tension between some expensive "tech champions" and fundamentals?

Fundamentals-based investment decision-making cautions against analysts "rationalising" abnormally high- or low market valuations with special "this time it's different" arguments. The key test will be the degree to which, once the enterprise-flattering cheap liquidity of the post-pandemic era has finally receded, the expensive enterprise of market in question can deliver sustained productivity or profit gains.

Regarding the "Artificial Intelligence – Robotics- Web 3.0 – Crypto - nexus," the jury is not only still out, rather,

the jury has not even been selected yet. Investors with a long-term investment horizon may be satisfied to obtain their thematic exposure via specialised funds, but we think it is safer to allow the most agile and best-resourced existing tech. giants to demonstrate what they can achieve with AI, before committing to more than a nominal holding. Otherwise, the risk is that pure enthusiasm on behalf of a corporate could easily lead to over-priced acquisitions which might ultimately have to be written down (or written off.) Our approach, as ever, is to consider the Quality dimension of any product or process before investing and not to make heroic assumptions about the inevitability of any new technology necessarily making the grade on critical comparative tests such as Return on Operating Capital and long-term earnings compounding capacities.

A new industry should not change investment disciplines

In short, even if the profitability, productivity and generally transformative claims of emerging Generative AI technologies become demonstrable, each individual investable entity should still be thoroughly assessed on the same metrics that have proven their worth for other parts of an individual portfolio.

In International Equities, we fully endorse the investment process clearly and consistently applied by our asset management partner, Morgan Stanley Investment Management. This is summarised below:

Identify High Return Companies

- High unlevered returns on operating capital employed (ROOCE)
- High gross margins (pricing power)
- Capital-light business models driving free cash flow (FCF) generation
- Strong balance sheet

Make Sure Returns Are Sustainable

- Ability to remain relevant through powerful intangible assets including brands and networks, sustaining high barriers to entry
- Returns are sustainable against material threats or improvable through material opportunities, including environmental or social factors
- Dominant market shares, helping protect against new entrants
- Stable sales– often repeat business, driving recurring revenues
- Steady organic growth and geographic spread

Confirm Management's Commitment to Sustaining Returns

- Focus on return on capital rather than sales or earnings per share (EPS) growth
- Capital discipline (reinvest at high returns or return the excess capital to shareholders)
- Committed to innovation and investment in franchises
- Review management incentives
- Sound governance structure
- Engagement on material issues or opportunities where relevant, including ESG factors

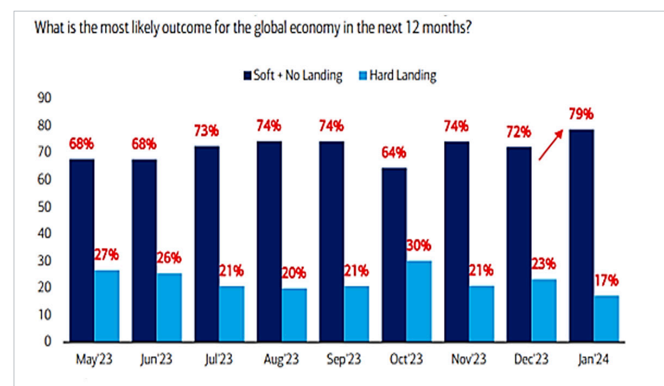
Valuation preferences

- A focus on free cash flow metrics (FCF) and FCF yield, DCF, EV/NOPAT i.e. EV = Enterprise Value [Market Value plus Net debt] / NOPAT = Net operating profit after tax.)

In our Sustainable Global Shares Fund, companies which successfully satisfy these criteria are considered "Quality" businesses worth holding over the medium- and long-term. At present, only two of the companies in the "Super-7" make the cut; Microsoft and Alphabet (Google.) Additionally, other portfolio holdings such as the Taiwanese chipmaker TSMC and the Irish-American IT Consulting and professional services leader, Accenture, have very significant engagements in the infrastructure and applications engineering for the Generative AI era. However, these companies have earned their place in the portfolio according to the investment criteria itemised above, rather than due to the kind of associative hype coupled with hazy developmental objectives that certain other "Super-7" enterprises are adept at cultivating.

Global asset managers expect soft landing, after hard tightening

As global economic data continues to suggest the previously common expectation of global recession accompanied by still-high interest rates was too pessimistic, the preponderance of major investment managers now see a benign 2024 adjustment phase, allowing unemployment to remain low and interest rates to be very gradually ratcheted down.

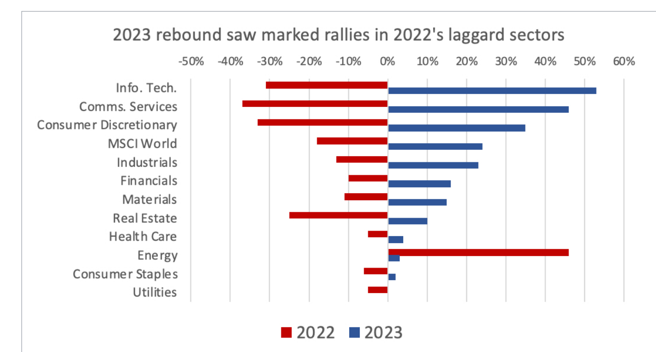


Source: Morgan Stanley Investment Management

This is certainly our own central scenario. However, it is important to also consider the primary risk scenario, which is essentially a resurgence in inflation, most probably due to some intensification of geopolitical

pressures and conflicts, the unintended consequences of populist policy swings, and / or unanticipated sharp shifts in currency exchange rates. Were this to transpire, it is worth considering the classically defensive equity industrial sectors that have not yet participated in the 2023 resumption of confidence: Health Care, Consumer Staples and Utilities.

Sectors which hedge against too-soft a landing should be retained



Source: BankofAmerica, Bloomberg

A final key question remains, whether the impact of prior rises in interest rates on the world economy has been lower this cycle than in the past, or whether still more of a negative impetus is yet to come through. Historically, since 1950, it has taken an average period of between two and three years after rate hikes begin, for the US economy to slow / stall to recession speed. Given that the US Fed began tightening policy rates only in March 2022, it is plausible that the full impacts will not be felt until mid-2024 and will suppress activity at a time when many costs to consumers (mortgage and loan interest rates, energy prices) remain a burden. That would introduce significantly more intense margin pressure across the entire corporate landscape, and it could see the Defensives finally show portfolio diversification merit.

Strategy conclusions

Our central market views for early-2024 are:

- Equities (as a whole) will potentially see average annual returns close to their long-term norms in the next 3-years with interim weaker periods; selected equity sectors and markets still have scope for resilience and desirable investment features. There are all-weather stocks and defensive sectors that have lagged in recent years.
- For instance, listed real assets have superior, defensible yields, in a fraught macroeconomic and geopolitical phase. Real Asset's historical sensitivity to bond yields (as they trend down) may be supplemented by their cashflow surety, inflation-hedging qualities and (for Infrastructure) non-cyclical defensive merit. Bond yields have adjusted well, and may now plateau, which is positive for Real Estate looking forward one year, while Infrastructure may need weaker economies to again outperform as it did in 2022.
- Within the broader market sectors, thematic and valuation support in Utilities and Consumer Staples, Healthcare, and Software as a Service (SaaS) Information Technology enjoy pricing power which assists them to ride out sentiment storms and hedge against economic slowdown.
- Expect more M&A based on strong USD "war-chests" and also some abandoned corporate courtships as conditions shift and credit-distressed firms multiply in 2024-25.
- We see better compensation for duration risk in bonds. However, yield levels will remain volatile. Within fixed income, thematic support is ready to be a prime differentiator, as sovereign and corporate bonds face refinancing risks. We acknowledge sustainable or "green" bonds as a valuable theme.
- Default risk and credit quality are now on the radar and are likely to become a market focus in mid-late 2024 and set off portfolio re-allocations within and beyond bonds.

We are now traversing the expected global slowdown as the lagged impacts of tightening of policy around the world continues to impact the real economy, and asset markets adapt to protect existing capital gains by allocating funds toward "all-weather" securities.

Such desirable investments, which we are actively seeking out across all our asset classes, are resilient to both inflation and to profit challenges in a less stimulus-based, capital spending and productivity-led phase of economic growth. International assets are broadly preferred to New Zealand counterparts, where viable, as the key northern hemisphere trading economies have more diversified defensive industries and often, more adaptive economic regulation (whist allowing that electoral / policy change risk is ever with us and will intensify this year with the US Presidential election in November 2024.)

Greg Fleming

SALT
Funds Management

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