Contact Asset Management

INSIGHTS

OCTOBER 2023

Rates, Yields, Equities – This way, That Way

A month ago, you could almost hear Central banks around the world taking a huge sigh of relief, as it seemed they had more control over inflation than they did a year ago. However, global bond markets continue to exude caution on a potentially resilient inflation environment. In recent weeks, US Treasury yields continue to climb to new highs. In the UK, bond yields are at a 25 year high, pushing up the government's long-term cost of borrowing. The Australian 10-year bond yield is at its highest level since 2011.

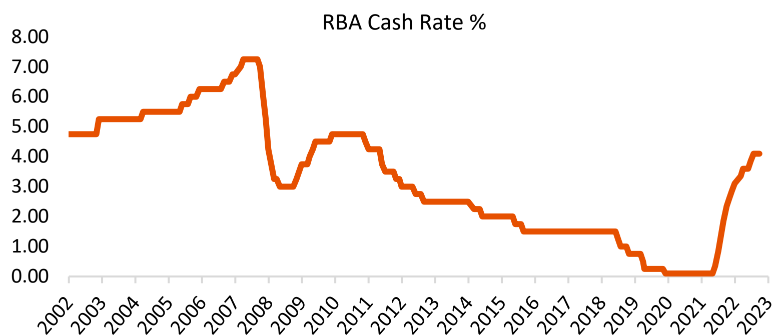
While high compared to historical levels, reported inflation numbers have been trending lower (on a quarter-on-quarter basis) for the past six months, ensuring that the rapid rise of interest rates globally looks like it may have stalled. Not stopped but stalled. The market is clearly divided. Will the next rate move to be higher (and stay higher for longer)? Or will it be an extended pause and potentially a rate cut by the end of the calendar year?

So where does this leave us in the equity investment cycle? In this Contact insights piece, we consider cash rates, bond yields and where we think we might be on the Investment Clock and what that may mean for equities. We believe the current uncertainty presents an opportunity for the long-term and patient Quality-focused investor. We also highlight an unusual disconnect in the performance and valuations in Small Caps versus Large Cap Equities.

Cash Rates – What Are They Doing Next?

Since May 2022, the Australian Cash Rate has increased by 4% off historic lows of just 0.10%. At the Reserve Bank of Australia's (RBA) meeting on Tuesday 3rd October 2023, the Board decided to again leave the cash rate target unchanged at 4.10%.

In Michele Bullock's first media release as Governor, she stated that "*higher interest rates are working to establish a more sustainable balance between supply and demand in the economy and will continue to do so. In light of this and the uncertainty surrounding the economic outlook, the Board again decided to hold interest rates steady this month. This will provide further time to assess the impact of the increase in interest rates to date and the economic outlook.*"



Inflation globally has been high for some time. However, in many economies the data suggests that inflation has passed its peak. In Australia, headline inflation peaked in December 2022 at approx. 8% and was last reported in August at 5.2%. But, as Governor Bullock expressed in her statement *"Inflation is still too high and will remain so for some time yet."*

In the near-term, it is likely that inflation will stay high compared to historical levels. Anecdotal evidence suggests that grocery spend will continue to trend up as food inflation persists, oil prices are high so fuel prices will remain inflated, as too utilities with the price of energy. Property supply/demand is tight which should see rents continue to increase. We are also seeing higher pricing coming through from annual insurance premiums and constant pressure on wage growth and labour shortages.

Although off its peak, inflation is likely to remain higher for longer. It is what the RBA do with rates that will determine how equities respond. We are hopeful that they take a long term pause before looking to cut within the next 6-12 months. Unfortunately, at present the market remains overly focused on the macro. As long-term investors, we need to be conscious of the macro, yet remain diligent and disciplined on fundamentals which includes stock picking. We continue to believe that we are in a stock pickers market and a focus on quality companies remains the most sensible strategy.

Bond Yields – This way or That Way?

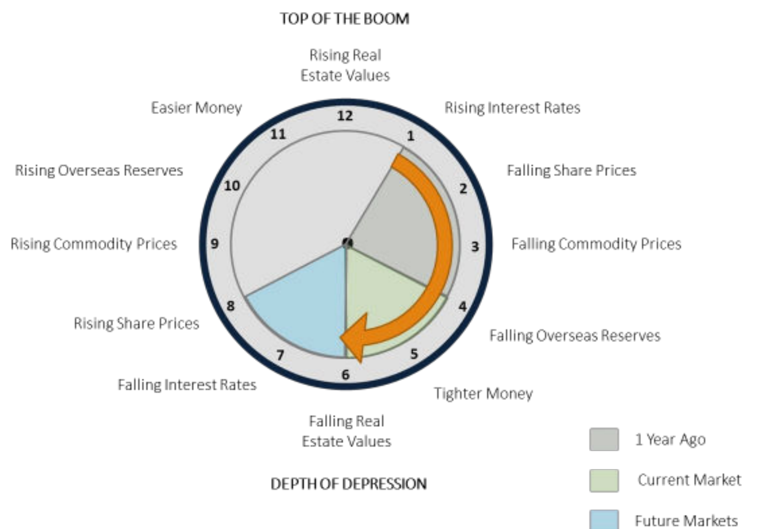
In recent weeks, US Treasury yields have continued to climb on the “higher for longer” trade. Recently, the US 10 year bond yield rose to 4.8%, while the 30 year yield went through 5.0%, the highest levels since 2007. Global equities markets have retreated, with multiple sessions in the red. However, it may not take long for the Bond market to cool, as lower than expected inflation and labour data is released.

Source: US 10-year Treasury - US10YT

Some economists have even brought forward their first rate cut estimates. There have been many Federal Open Market Committee (FOMC) voters chiming in with their views, with Mary Daly (voter in 2024) stating that FOMC may be able to refrain from hiking more if the labor market and inflation continue to cool. "Holding rates steady is an active policy action". Raphael Bostic (voter in 2024) said they should hold rates at elevated levels "for a long time", yet Loretta Mester (voter in 2024) said “one more hike may be needed this year”. The constant rhetoric from FOMC members (with often polarising opinions) only adds to investor uncertainty.

Investment Clock, We’re Getting Close to 8 o’clock

We have written about the predictive power of the Investment Clock previously and we continue to watch it carefully. We have seen the banks continuing to firm up lending to both mortgages and business and significant growth in credit funds. We expect that the Australian Banks will pass the worst of the “Fixed rate mortgage cliff” by December 2023, where an estimated $275 billion worth of fixed rate loans are refinanced. To date, the negative impact is less than originally feared, but we’re keeping an eye on it.



The outlier to the clock in the current environment is falling real estate values. While Commercial Real Estate values have been challenged, residential property prices have been robust. Average house prices are now expected to lift upwards of 8% in 2023 and a further 5% in 2024[1].

We are less optimistic on the short-term outlook for residential property and believe that it is a lack of supply rather than robust demand, which explains the recent resilience. REA.com listings were up 7% in September, the first positive comp in some time. Increased volume could put the brakes on residential market strength. The other point to note is that affordability as it stands has rarely been worse.

Going back to the rise in Bonds yields, as this is a key driver for the REIT sector, we have seen the REIT sector sell off approx. 10%. This means asset values will come under further pressure, as many property managers who hoped that stabilising rates may give reason not to have to move cap rates too much. That optimism has now passed, and we are likely to see a re-rate on

[1] Source: Jarden

asset values with some physical property sales expected over the coming months to reset the market. However, a lot of this negativity is already in the price and long-term investors will be seeing a lot of value in the REIT sector.

All told, if the Investment Clock holds true, we are approaching more accommodating equity markets. Falling Real Estate Values takes us past 6 o'clock, the end of the rising rate cycle takes us past 7 o'clock. Then we swing back into more positive territory of rising share prices (8 o'clock). Our recommendation is to stay the course.

Small-Caps versus Large-Caps – The Discount Continues

We have also seen a continuation of an interesting theme over the past two years, whereby large ASX stocks have outperformed their smaller counterparts by some margin. On a rolling year basis, the S&P/ASX Top 100 Accumulation Index increased by 12.8%, whereas the S&P/ASX Small Ordinaries Accumulation Index increased 6.6%. We continue to anticipate some mean reversion in the performance of small caps.

Conclusion

We do not claim to have a Crystal Ball. We don't know where bond yields will trade. We don't know what Central Banks around the world will do next. What we do know is that the market does not always act rationally in the short-term. What we have seen recently with the bond market and subsequent reaction by equities appears to be another illustration of this. We take a long-term view and the longer one plans to hold, the more important quality becomes. At Contact, we define "Quality" as a business that:

- Has an identifiable competitive advantage,
- Is profitable, has growing earnings and generates cash,
- Generates attractive returns on its invested capital,
- Has a strong Balance Sheet or, at least, is appropriately geared for its stage of growth,
- Is conscious of ESG and scores favourably with MSCI ESG Ratings, and
- Is run by capable, dedicated and trustworthy people. Ultimately, they are founders of the business or have significant "skin in the game".

Markets can be volatile, and September 2023 was a volatile month. Yet again, we are looking beyond short-term market variability. Too many investors use share price as a signal. They believe that if the share price is rising the company is good. If the share price is declining, something must be wrong. In the short-term, share price is noise and we instead focus on the underlying fundamentals of the business. Quality will win.

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