Quarterly Investment Report
October 2023

Defying Trends

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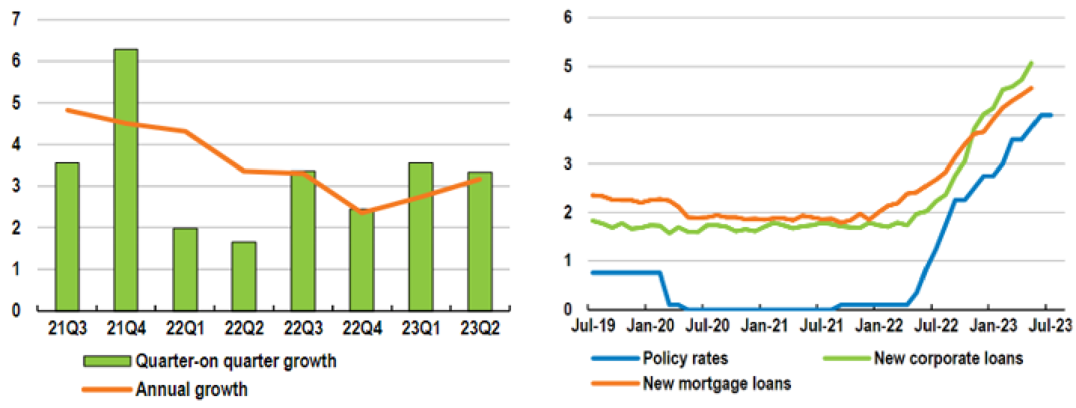
Summary

Global growth accelerated despite a 4% increase in rates.

The resilience of the global economy amid rising interest rates has surprised investors. Global growth accelerated in the first half of 2023 despite a 4% increase in policy rates from their 2022 lows. Furthermore, 2H-2023 estimates are being revised upwards.

Resilient growth as rates rise

Global GDP growth & median borrowing rates across advanced economies



Source: OECD Interim Economic Outlook 114 database; and OECD calculations – October 2023

While higher rates have caused inflation to moderate in major economies, the underlying strength in business and consumer activity threatens this trend.

Uneven debt burden and a favourable job market has protected parts of the economy against higher interest rates.

The uneven debt burden across households and corporations and a favourable job market have protected parts of the economy against higher interest rates, defying the central bank's expectations.

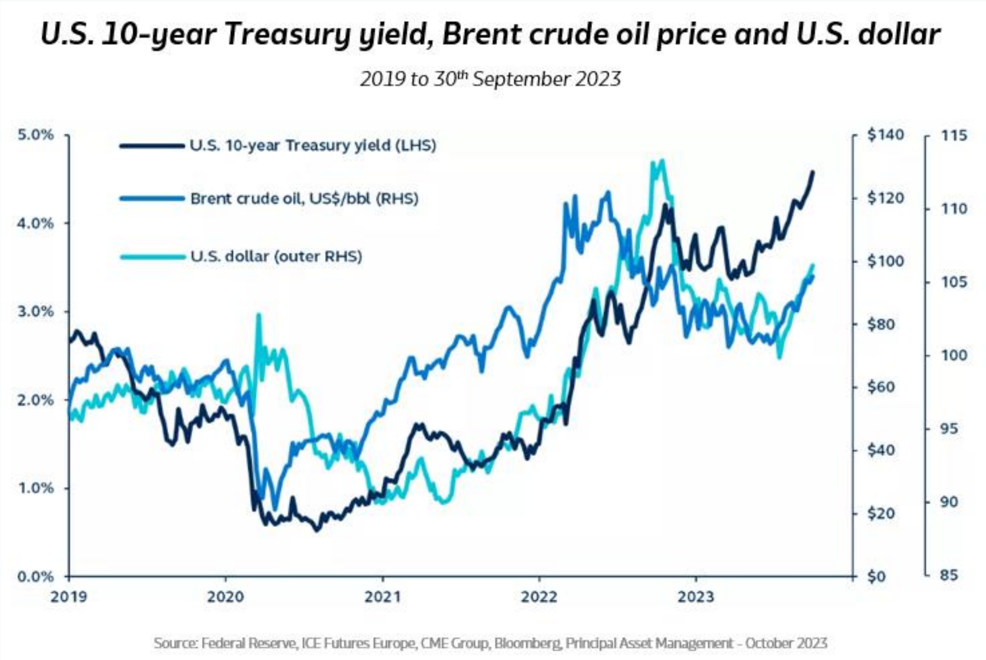
Companies with no debt or locked in low rates in 2020 and 2021 have benefited.

Companies with no debt or locked-in low rates in 2020 and 2021 have benefited from higher interest rates. Thirteen S&P500 companies, including Apple, Microsoft, Meta, and Google, have a combined $1 trillion in cash and investments, supporting their earnings in uncertain times.

Locally, higher interest rates have benefited around one-third of Australian households who own their homes outright, resulting in a 5% increase in savings over the past year. Furthermore, the infamous "fixed-rate mortgage cliff" has been milder than anticipated, with RBA data showing Australian households with fixed-rate mortgages have savings of at least 12 months' worth of mortgage repayments and decade-high wage growth.

Despite the positive economic and corporate activity, there are ongoing recession risks.

Despite the positive economic and corporate activity, there are ongoing recession risks, evident through higher bond yields, oil prices, and the strength of the U.S. dollar. These concerns stem from the belief that the global economy's resilience may prevent inflation from reaching target levels, forcing central bankers to tighten financial conditions excessively. The consensus probability of a global recession stands at around 50%, suggesting that a recession may be delayed but not entirely avoided.



Robust global economic activity will keep interest rates elevated for an extended period to control inflation.

Our House View supports the notion that robust global economic activity will keep interest rates elevated for an extended period to control inflation. Still, this is not a linear transition and may take another 12 months, causing further bond and equity market volatility, a key reason for our underweight exposure to Global Equities since Q2-2023.

Opportunities in fixed interest, specifically private credit strategies.

Against this backdrop, we see more opportunities across fixed interest, specifically with private credit strategies offering high-quality investment grade debt with an 8% per annum yield and lower capital volatility than public markets. While default rates may rise, average recovery rates of 70-90% are expected to keep net losses low in a well-diversified loan book, offering equity-like returns of 8% to 10% per annum.

Importantly, our overall asset allocation preferences align closely with long-term targets, including investments in both public and private markets. This approach has benefited our clients over the past year. We recognise that the best buying opportunities often arise when caution is widespread, and missing these opportunities can hinder future compound returns. In the event of further market deterioration, we plan to allocate more cash to public equities at attractive entry points.

Positioning

As of October 2023	Positioning (DAA)		
Asset Class	Underweight	Neutral	Overweight
Cash			
Fixed Interest			
Australian Fixed Interest			
Global Fixed Interest			
Australian Equities			
Global Equities			
Developed Market Equities			
Emerging Market Equities			
Property			
Australian Property			
Global Property			
Alternatives (Inc. Infrastructure)			
Infrastructure			
Other Strategies (Private Markets, Hedge Funds)			

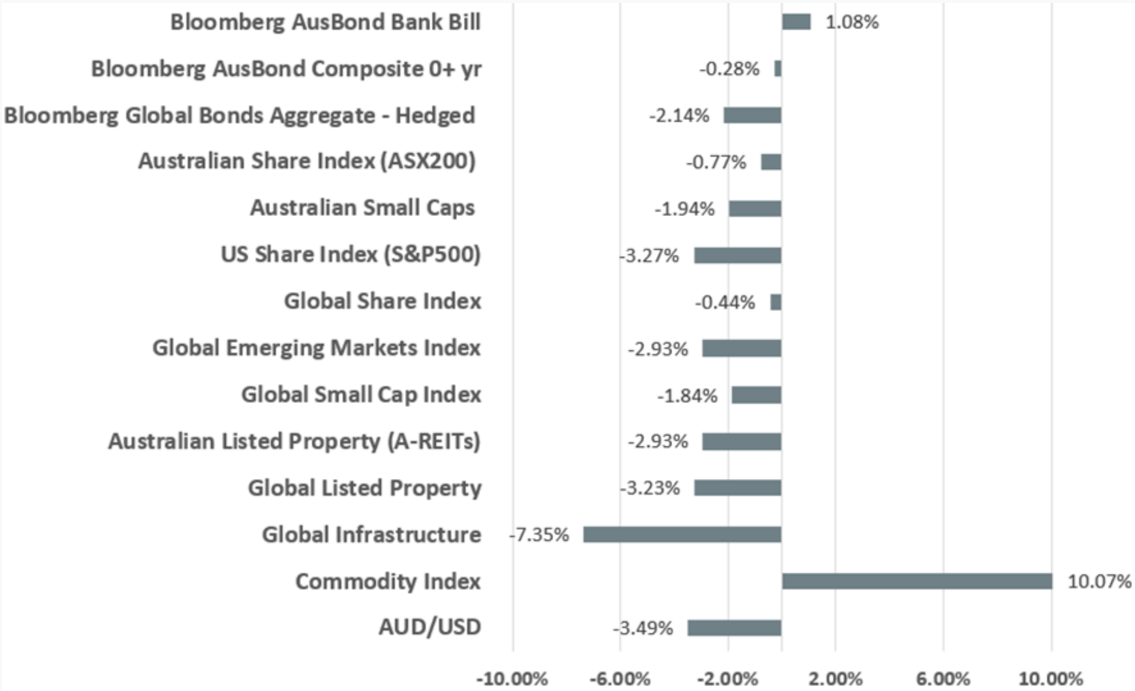
Positioning Definitions

Overweight >= 2.0% above benchmark strategic asset allocation weight

Neutral <= 2.0% versus benchmark strategic asset allocation weight

Underweight >=2.0% below benchmark strategic asset allocation weight

Market Returns – Q3 2023



Overweight

Neutral

Underweight

Cash

Themes

- The RBA cash rate remains at 4.1%.
- Interest rates have increased materially over the past year, and cash now offers investors some return on capital.
- Cash provides capital preservation and liquidity in a volatile market.

Strategy

- Current term deposit rates <12 months are attractive in an uncertain environment.
- We are holding some cash for future growth or income opportunities.

Positioning

- **Neutral** – downgrade to Neutral. We are allocating some Cash towards higher-yielding fixed interest, reducing reinvestment risk across cash whilst maintaining liquidity for future opportunities.

Fixed Interest

Themes

- Global bond yields surged in September, with the U.S. 10-year yield ending the month at 4.62%, a 0.82% rise for the quarter, producing a loss in the Barclays Global Aggregate (AUD hedged) index of 2.1%.
- Australian bond yields ended the September quarter at 4.5%, up almost 50 basis points in the month to reach their highest level since 2011.
- Since peaking at the end of 2020, the global bond index has dropped almost 14%.
- Several factors contribute to the rise in bond yields, but the main driver is better-than-expected economic growth.
- High-yield bonds are vulnerable to credit spread widening as prices haven't adjusted for the likelihood of a recession and higher defaults.

Strategy

- We have increased our holdings in long-term bonds as yields rise, which provides added income and diversification advantages. We prefer domestic bonds due to their higher absolute yield and lower political risk.
- We'll maintain an overweight allocation to floating rate credit strategies, prioritising high-quality assets to reduce credit risks.
- Private credit is delivering returns similar to equities but with lower risk.
- We expect private credit to deliver consistent returns, supported by a more favourable lending environment (terms) and higher base interest rates. Variance in risk and underlying sector exposures are high, so manager selection is imperative in Private credit.

Positioning

- **Overweight** – We maintain our **overweight** position to Fixed Interest given the improved yields, economic backdrop and capital preservation benefits.

Overweight

Neutral

Underweight

Australian Equities

Themes

- The Australian equity market lost 2.8% in the month and -0.8% for the quarter, slightly ahead of U.S. markets. The domestic market is up just 3.7%, well below global markets for the year to date.
- As was the case globally, the theme was higher bond yields and a contraction in P.E. multiples. However, unlike the U.S. market, the earnings outlook for Australia is very subdued, with consensus EPS growth for the next 12 months around -2%.
- A growth slowdown is expected, but positive offsets are emerging in housing and immigration. Australia has one of the fastest population growth rates in the developed world.
- Older demographics and no mortgage households are driving consumer spending.

Strategy

- Valuations align with 20-year averages in the face of growing concerns over higher costs and slower growth dragging on margins and earnings.
- Despite anecdotal evidence of softer revenue growth and rising cost pressures, we have not seen a material adjustment to ASX200 earnings expectations over the medium term.
- China's stimulus and demand for yield may provide a relative cushion to parts of the market.
- High-quality stocks with defensive earnings are expensive, while the market heavily penalises those with less certain near-term outlooks.

Positioning

- **Neutral** – We maintain our **neutral** position on Australian shares, actively looking to buy upon market weakness.

Overweight

Neutral

Underweight

Global Equities

Themes

- Global equity markets declined 4.3% in September, taking the September quarter loss to 3.5% following a solid first half.
- The recent convergence of rising interest rates, soaring oil prices, and a strengthening U.S. dollar has created a concerning growth scenario.
- The surge in bond yields was the major driver, particularly the rise in U.S. real yields from 1.59% back in June to 2.27% by quarter-end.
- Markets have been blindsided by the better-than-expected U.S. economy, which has so far coped with the 500 basis point rate hiking cycle.
- Consensus expectations of a short and shallow U.S. recession remain, as weak consumer spending is offset by stronger corporates that are insulated from higher rates (fixed rate debt and net cash position).
- Developed markets 12-month forward P.E. sits at 16.3 times, in line with the average of 16.2.

Strategy

- Despite better-than-expected company data, we believe FY24 earnings for the broad global index will be lower than consensus in a recession or no recession scenario.
- With limited prospect of an upgrade to earnings expectations, global equity market returns will likely be muted relative to other assets - particularly until bond yields peak.
- Some areas of the market provide valuations at recessionary levels with modest upside – small to mid-caps.
- Emerging markets look cheap from a relative basis, although ASX200 may be a better risk adjusted return with similar growth drivers, i.e., China.

Positioning

- **Underweight** – In the face of increased uncertainty and valuations, we maintain our underweight to Global equities – mainly led by the U.S. equity market.

Overweight

Neutral

Underweight

Property

Themes

- Australia-listed property declined 8.6% in September, taking the quarter's loss to 2.9%. Global listed property fell 5.3%, for a 4.4% decline for the quarter.
- The sharp lift in real yields hit REITs harder than most equity sectors during September.
- Recent transactions suggest the market is too bearish on major office REITs. In August 2023, Dexus sold One Margaret St Sydney at a 16% discount to the December 2022 book value; however, it is still +9% above the enterprise value of the listed security.
- Retail exposures face recession risk, but two years of strong retailing has helped landlords sign good tenants on long leases.

Strategy

- The bond sell-off has challenged listed property (REITs) and is now deeply discounted. Once yields have peaked, REITS should offer a compelling opportunity.
- We retain some selective A-REIT's (Australia) that are trading at a discount to NTA and provide some earnings growth exposure, including inflation-adjusted rents.
- Our portfolios have no exposure to unlisted property assets. History supports our valuation lag concerns about unlisted property assets, specifically low-quality office and retail.

Positioning

- **Neutral** – We maintain a **neutral** allocation to property, seeing more mean reversion opportunities in the A-REIT market.

Overweight

Neutral

Underweight

Alternatives

Themes

- Listed global infrastructure was down 4.2% in September and 7.4% for the quarter as the almost 70 basis point lift in U.S. 10-year TIPs yields undermined valuations.
- Private market strategies delivered positive returns during the quarter of between 1.0%-2.5%.
- Hedge funds continued to deliver positive returns, with our selected exposure achieving a return of 9% for the quarter.
- Performance dispersion across private asset managers is wide, highlighting the importance of manager selection and manager diversification – e.g., managers who prepared for higher rates v's not.

Strategy

- We are looking to increase our Hedge Fund allocation with some profits/distributions from Global Equities as a tail risk hedge to the downside risks in the market.
- Our preferred unlisted asset managers have delivered strong relative returns over the past 12 months, even with asset valuation write-downs, providing diversification benefits to clients across income and growth strategies.
- While higher real yields are a headwind for infrastructure, its predictable cash flows will be necessary.
- Recession-year vintages across Private Market strategies typically generate superior returns. Therefore, we favour allocating capital to new strategies relative to existing ones.

Positioning

- **Neutral** – We maintain our **neutral** position, favouring quality strategies with consistent performance through market cycles.

Independent Advisory Board

The Advisory Board believe a robust governance framework is critical in forming a House View and making effective Asset Allocation decisions. An Advisory Board charter governs the process and comprises experienced investment professionals with diverse areas of expertise, reflecting an industry best practice in decision-making.

The Advisory board is responsible for setting and reviewing the House View, upholding the fundamental values and investment philosophy of Mackay Private.

The Advisory Board meets quarterly to meet intra-quarter as required. Voting members make all dynamic asset allocation decisions of the Advisory Board. Please visit our webpage, www.mackayprivate.com or contact us directly at info@mackayprivate.com or 1300 721 986.

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