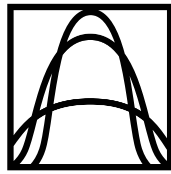


INNOVA
ASSET MANAGEMENT

QUARTER THREE 2023 | TRADITIONAL
MARKET OUTLOOK REPORT

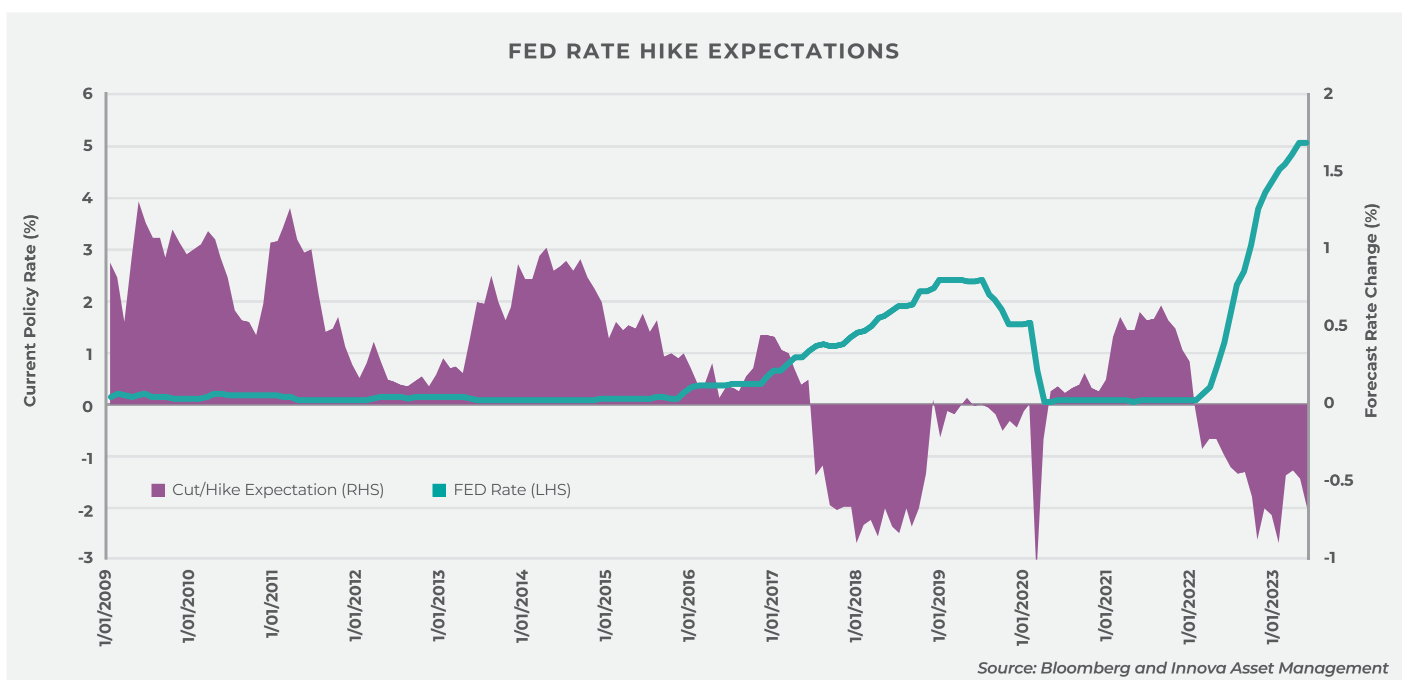
KEY TAKEAWAYS

- 2023 has seen two major narratives: the anticipated global recession and the AI-driven equity rally.
- Equity markets have rallied, fuelled by optimism surrounding AI and specific sectors, while defensive sectors have lagged.
- Discrepancies between market behaviour and leading economic indicators raise concerns and call for a cautious approach.
- The economic outlook points to a slower economy and a potential recession, potentially leading to volatility in equity markets.
- Multiple leading indicators suggest a high probability of a US recession, but this is not yet reflected in market prices.
- Equity markets appear expensive based on various valuation metrics, while bond market volatility warrants caution.

WHAT'S HAPPENED IN MARKETS

2023 has been marked by two major narratives: the looming global recession and the AI-driven equity rally. Professional economists and market investors have observed a slowdown in inflation and cracks in the economy. Despite this, equity markets have rallied due to optimism surrounding AI, with NVIDIA as a notable example. Looking at equity markets, the performance has been dominated by cyclical and growth sectors, while defensive sectors have lagged. This performance disparity raises questions, as historically, sectors like healthcare, energy, and consumer staples have held up better during recessions. The discrepancy between market behaviour and leading economic indicators is concerning.

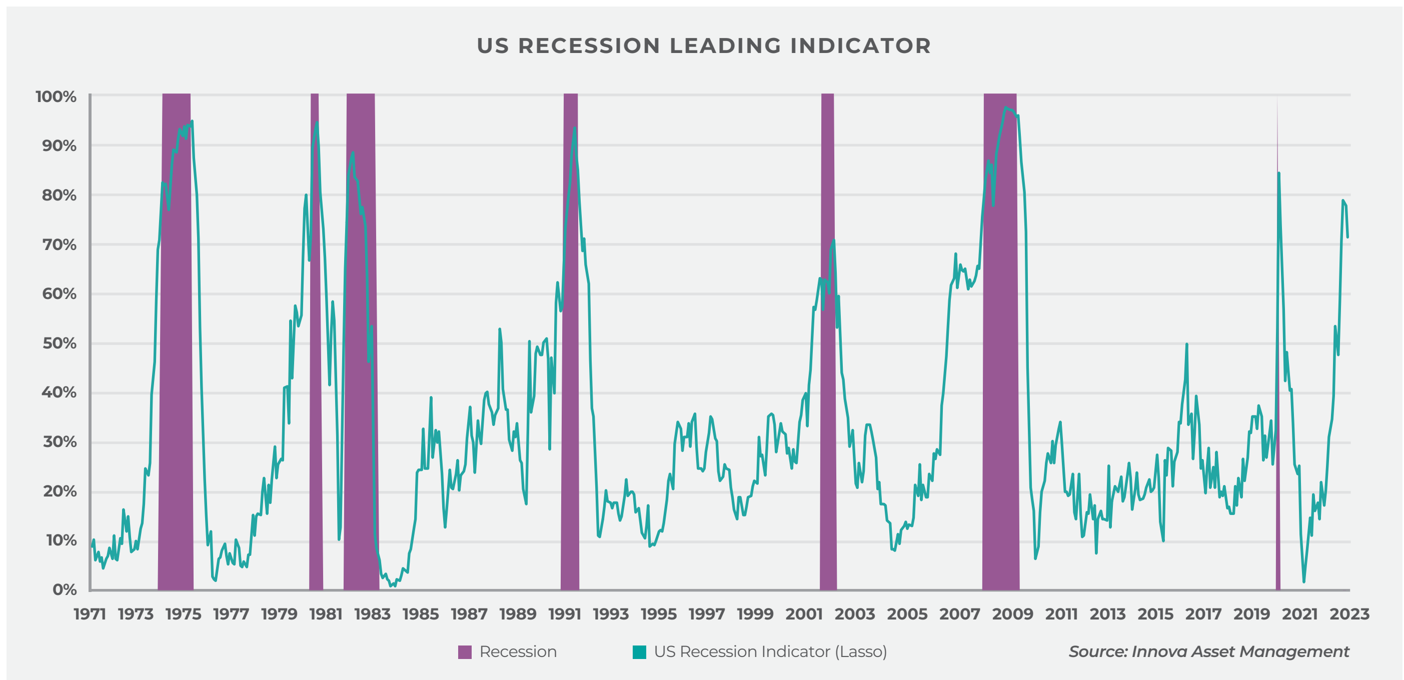
The optimism in the market stems from a resilient consumer and the hype surrounding AI, with expectations of rate cuts due to receding inflation. However, this optimism may be misplaced. If the economy avoids recession and equity markets do not price in a true earnings recession, rates are likely to stay higher for longer, potentially affecting corporate earnings. Moreover, the concept of a "rolling recession" or recessionary conditions in some parts of the economy is being overlooked. Inflation is retreating, but other factors like manufacturing PMI, housing starts, credit tightening, and retail sales indicate a broader economic picture.



Source: Bloomberg and Innova Asset Management

INNOVA HOUSE VIEW

US equities are showing signs of being expensive based on various valuation metrics. When combined with our economic forecast of a slower economy and the potential for a recession, the next 12-18 months could be marked by increased volatility in equity markets. Our internal composite and leading indicators point to an uncomfortably high probability of a US recession, which could significantly impact forward earnings, even more than what the market is currently pricing in. Other research firms like Rosenberg Research and Variant Perception also highlight the likelihood of stress and volatility in the US equity market.



While US earnings are falling, the consensus for 12-month forward implied earnings growth remains positive. This suggests that equity markets are not fully pricing in the risk of a recession, yet heightened bond market volatility (which is the highest in recent memory) is certainly suggesting a cautious stance. It's important to note that the bond market has a better track record in predicting market movements than the equity market.

The current AI-driven equity rally in the US has drawn comparisons to the dot-com era, raising concerns about whether prices have moved too far, too fast. Paying high prices for a broad sector of equities rarely leads to reasonable returns, especially within a 3-5 year timeframe. While we acknowledge the importance of focusing on longer-term returns, a global economic slowdown or recession would negatively impact earnings for the next year or two, potentially making the current prices of mega-cap growth stocks unjustifiable. At Innova, we adhere to the principle that "Price drives long-term returns." As a result, we maintain a defensive posture and patiently await opportunities to acquire quality assets at reasonable prices.

HOW WE'RE POSITIONING OUR PORTFOLIOS

In the June quarter, we strategically adjusted our portfolio positioning to manage risk and seize emerging opportunities. Our portfolio remains underweight in equities, particularly US equities, while maintaining an overweight allocation to fixed income. To manage credit risk, we reduced our exposure to subordinated debt and increased our allocation to US Treasuries as a hedge against the anticipated economic slowdown in the US. Although we don't plan to make immediate changes, we are flexible in rotating our sub-asset class allocations to adapt to the evolving market environment.

While maintaining a key overweight position in value equities, we took the opportunity to realise profits and transitioned to a more momentum-based strategy within Australian Equities to diversify our

factor exposure. Our strategic focus remains on UK equities and Emerging Market/Asian equities, both of which have shown promising prospects according to our systematic outputs. Given supply-chain bottlenecks, high input costs, and pressure on earnings margins, we are cautious about tilting towards quality equities due to their high valuations.

With a defensive stance, we prioritise higher credit quality and duration exposure to navigate potential adverse conditions. We are actively evaluating growth opportunities, particularly in global small caps, global quality small caps, domestic small caps, and G-REITs, as they have recently experienced price weakness and relative underperformance compared to mega-caps. By aligning our portfolio with these adjustments, we aim to optimise risk-adjusted returns while remaining vigilant of market dynamics and potential headwinds.

RECENT PORTFOLIO CHANGES

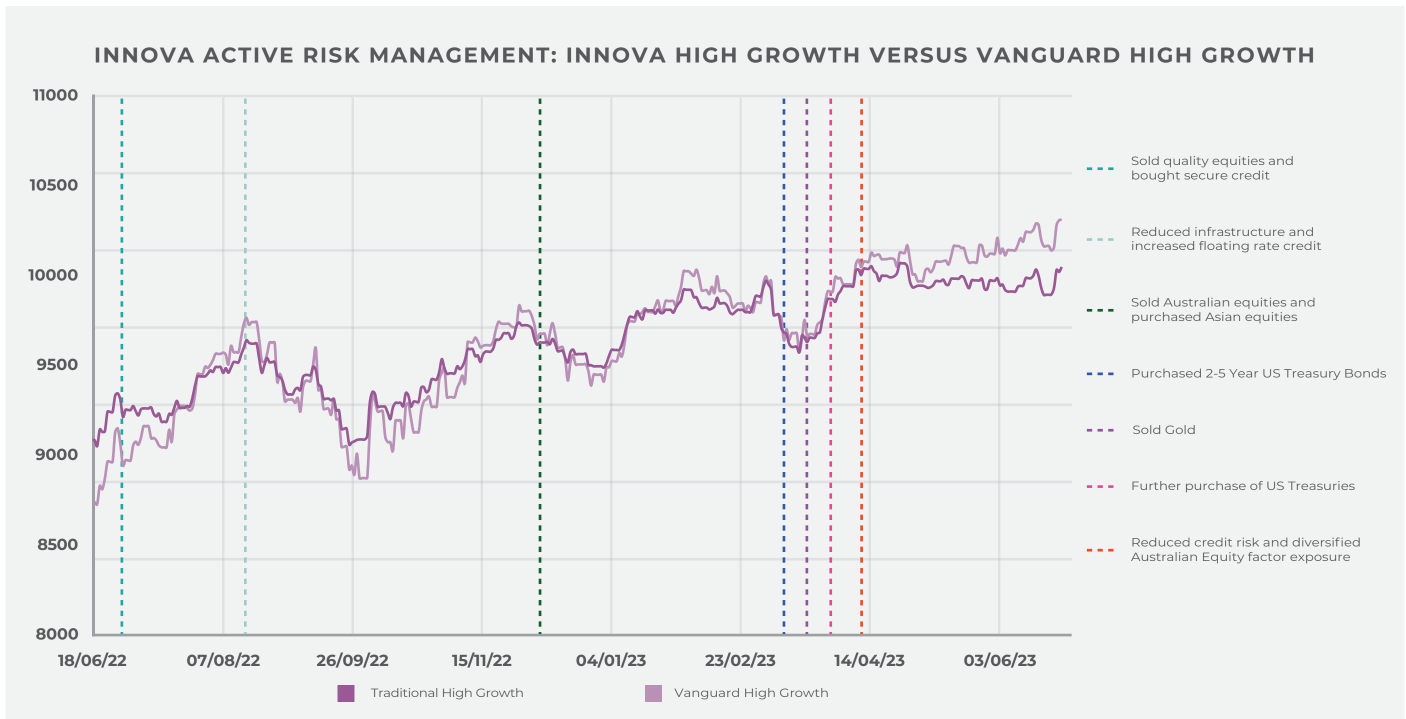
12/04/2023 US Treasuries (Buy) & Subordinated Debt (Sell) / Momentum Aus Equities (Buy) & Value Aus Equities (Sell)	Our modelling was continuing to present an uncomfortable likelihood of recession, leading us to take steps to reduce credit risk and enhance the defensive nature of our client portfolios. To achieve this, we opted to further increase our allocation to US Treasuries, which serve as a reliable hedge against the expected economic slowdown in the US. Additionally, we decided to capitalise on the strong performance of value equities by taking some profits and diversifying our factor exposure within Australian Equities. We achieved this by allocating to a momentum-based strategy that had not performed as robustly during the period.

PERFORMANCE

PERFORMANCE TO JUNE 30TH

	1 MTH	3 MTH	6 MTH	1 YR	3YR	5YR	10YR
CONSERVATIVE							
Innova Active Conservative Portfolio	**0.10%**	**0.40%**	**3.00%**	**4.49%**	**3.06%**	**2.84%**	**3.77%**
Morningstar Benchmark	-0.38%	-0.48%	2.41%	2.87%	0.30%	1.37%	2.63%
MODERATELY CONSERVATIVE							
Innova Active Moderately Conservative Portfolio	**0.33%**	**0.86%**	**3.84%**	**5.76%**	**4.98%**	**3.75%**	**4.87%**
Morningstar Benchmark	0.16%	0.32%	3.31%	4.36%	2.29%	2.46%	3.63%
BALANCED							
Innova Active Balanced Portfolio	**0.56%**	**1.19%**	**4.76%**	**7.12%**	**6.80%**	**4.76%**	**6.11%**
Morningstar Benchmark	0.86%	1.31%	4.96%	7.56%	5.26%	4.04%	5.33%
GROWTH							
Innova Active Growth Portfolio	**0.90%**	**1.68%**	**5.60%**	**8.45%**	**8.76%**	**5.60%**	**7.38%**
Morningstar Benchmark	1.33%	1.95%	6.09%	9.27%	7.03%	4.97%	6.42%
HIGH GROWTH							
Innova Active High Growth Portfolio	**1.06%**	**1.81%**	**5.96%**	**9.10%**	**9.76%**	**6.17%**	**8.15%**
Morningstar Benchmark	2.22%	3.30%	8.32%	12.50%	9.36%	6.13%	8.01%

PORTFOLIO CHANGES (PREVIOUS 12 MONTHS)



31/03/2023 US Treasuries (Buy) & Relative Value (Sell)	The bond market has been unstable lately and other investment options are now offering higher returns, making less traditional fixed income options less attractive. As a result, we plan to invest more in US Government bonds and less in other fixed income strategies.
22/03/2023 Cash (Buy) & Gold (Sell)	Gold prices had reached record highs in Australian Dollars and had successfully protected portfolios during periods of equity market volatility, which was its intended purpose. However, at the price it was trading at, we believed the upside potential for gold was limited, and the downside risk significant. Therefore, we decided to sell some of our gold holdings to take profits. We allocated the proceeds to cash as we anticipate continued volatility in equity and bond markets.
13/03/2023 2-5 Year US Treasury Bonds (Buy) & Global Government Bonds (Sell)	Our economic indicators suggested a high likelihood of a global economic slowdown or recession, which was concerning. To hedge our equity market exposure, we found the most attractive option to be 2-5 year US Treasury bonds. These bonds offered an attractive inflation premium, yielding around 5%, and have the potential for significant capital gains in the event of a stock market decline. To fund this investment, we sold Global Government Bonds,, as we believe a more US-centric allocation will offer a better return profile in the future.
08/12/2022 Asian Equities (Buy) & Australian Equities (Sell)	We decided to decrease our investment in Australian Equities because it had performed well, and we expected lower returns in the future. Additionally, we had concerns about the domestic economic landscape in 2023. Instead, we chose to invest the money in Asian equities because our short-term forecasts for this region were among the highest compared to other asset classes. After thorough research and analysis, we also felt comfortable with the risks associated with investing in Asia that we were previously concerned about.

15/08/2022 Floating rate credit (Buy) & Infrastructure (Sell)	We decided to decrease our investment in Infrastructure because it had performed exceptionally well over the year, making it expensive. Instead, we invested the money in diversified floating rate credit because it provided a better yield, had a lower price, and was more secure. Additionally, we diversified our credit exposure by bringing in another credit manager.
28/06/2022 Secure credit (Buy) & Quality Equities (Sell)	To minimize the risk in our portfolios, we decided to further decrease our equity exposure because we expected rising interest rates to cause more volatility in the markets and possibly lead to an economic slowdown. Specifically, we reduced our investments in quality and growth equities because we felt that despite the sector selling off, it still didn't factor in the likelihood of high inflation, interest rates, and a potential economic slowdown. Instead, we invested the money in floating rate notes that had A+ to AA- ratings.

Important Information

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