INNOVA
ASSET MANAGEMENT

QUARTER TWO 2024

RISK DEFINED

— MARKET OUTLOOK REPORT

Key Takeaways

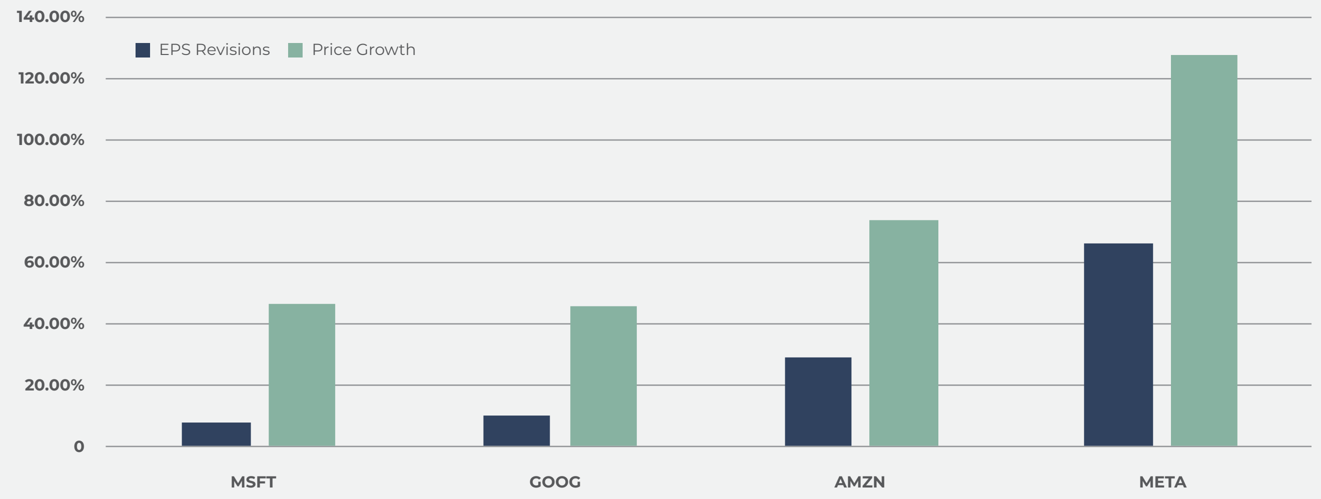
- In January, rate cut expectations in the US had reached what we believed to be highly optimistic and unrealistic levels. Many were factoring in a first rate cut as early as March, and as many as 6-7 .25% cuts in 2024.
- This helped spur on the advance in equities, but as the quarter played out, those expectations pushed out the likely date of the first rate cut, and drastically decreased the magnitude of cuts.
- Since October/November 2023 consumer sentiment has increased, which reflects the "surprise to the upside" narrative which has gone on. The positive surprises in economic data, especially the US, lead to greater optimism, higher bond yields and a new "reflation" narrative in 2024.
- GDP revisions have been positive, but the fuel being used for this GDP growth may have started to become a little less sustainable, as consumers have swapped a lot of their spending from excess savings to credit cards – which we know is not sustainable long term. However, household wealth has also increased, making this more serviceable and offering the 'wealth effect' trickle down to the consumer.
- Amongst 55 managers in the HUB24 Balanced SMA universe, 3 of Innova's portfolios occupied the top 5 performance results for March. Over a 3 year period, we retain 3 portfolios in the top 10 performers.

What's happened in markets

Equity markets globally continued their late 2023 rally into Q1 2024. In January, rate cut expectations had reached what we believed to be highly optimistic and unrealistic levels. Many were factoring in a first rate cut as early as March, and as many as 6-7 .25% cuts in 2024. This helped spur on the advance in equities, but as the quarter played out, those expectations pushed out the likely date of the first rate cut, and drastically decreased the magnitude of cuts. Nonetheless, equities continued to rally, even though the reason for that rally dissipated.

The primary argument for this was positive earnings – stocks were rallying because the earnings trend and earnings revisions were positive. Some of the more extreme examples over the past 12 months at a mega-cap level include Microsoft, Alphabet (Google), Amazon and Meta (Facebook) outlined below: The price growth was significantly higher than earnings revisions.

CHANGE IN EARNINGS FORECAST VERSUS SHARE PRICE MOVEMENT - 1 YEAR



This shows that whilst there has indeed been earnings growth, price movements have FAR outstripped earnings revisions.

Innova house view

- Economic conditions in the US appear to remain robust driven by US fiscal deficit spending as if it is in a recession, and supply side disruptions easing. There are some reflation trends coming through – expansionary Manufacturing for March (after 16 months of contraction), Nonfarm payrolls surprising to the upside, and heavy rises in commodity prices.
- These reflation conditions lead us to believe that pro-cyclical equities would likely be the beneficiaries if economic growth remains positive and robust.
- Other countries around the globe are not faring quite as well. Australian GDP growth is anaemic at best, Japan almost entered 2 quarters of negative GDP growth and Germany is in a technical recession.
- We see 2024 as being a year of persistently higher rates, cuts beginning in the latter part of the year, potentially as late as September, and overall slower growth than 2023.
- We are yet to see signs of a potential default cycle and labour market weakness, however with rates staying on hold and inflation remaining sticky, this is a potential risk at some point in 2024/2025.
- Whilst we believe the likelihood of a soft-or-no landing scenario seems far more likely now, a global economic rebound is certainly not assured, and we have had previous events where a fall in the share market has driven a subsequent recession.
- To us there are 3 major risks to be aware of and have hedges in place for:
    - A market driven fall in equity prices because prices just got too high.
    - A growth shock where growth begins to disappoint, and the recent positive trend reverses itself; and
    - An inflation shock where inflation remains persistently high or potentially increases again and this has not been factored into markets.

How we're positioning our portfolios

SUB ASSET CLASS	12 MONTH RETURN	LONG TERM RETURN FORECAST	CURRENT POSITIONING
UK Equity	7.4%	10.11%	Overweight
Emerging Market Equity	10.8%	8.08%	Overweight
Australian Equity	9.7%	7.79%	Neutral Weight
Asia Pacific ex Japan Equity	8.3%	7.31%	Overweight
Quality small cap Equity	28.8%	6.48%	Overweight
Global Value Equity	14.7%	6.37%	Overweight
Australian Value	11.8%	6.09%	Neutral Weight
Domestic Credit	5.4%	4.96%	Overweight
Global Infrastructure	2.0%	4.54%	Underweight
Cash	4.35%	4.32%	Underweight
Domestic Treasury	-2.0%	4.27%	Neutral Weight
Global Treasury	-1.6%	4.25%	Neutral Weight
Australian REITS	18.0%	2.87%	Underweight
Japanese Equity	32.6%	2.49%	Neutral Weight
US equities	24.6%	1.71%	Underweight
Global Quality	26.9%	0.49%	Underweight

- We maintain our positioning that more pro-cyclical regions, sectors and factors/styles should be the new leaders of the market if the US economy remains robust and we see a true reflation trade occur, and in fact this is how the market began playing out in March and into April this year.
- Value equities and relative value equity positions remain a key overweight.
- UK equities, via the FTSE100 ETF, continue to demonstrate outsized forecast returns from our systematic outputs, as do South Korean equities via the IKO ETF.
- We selectively changed some of our equity positioning, now taking a structural position in Quality small caps, as they share similar forecast earnings growth to their large cap counterparts, but at a much more attractive valuation point.

Recent portfolio changes

TRADE	SUMMARY
15/02/2024 Quality small caps (buy) & Global Agriculture (sell)	Global small caps had not participated in the 23/24 equity market rally and were trading at a deep discount to their large cap counterparts. We opted to focus on the 'quality' end of the spectrum, which has historically shown to provide protection if a sell off were to occur, so allocated to global quality small caps. This was funded by selling our position in Global Agriculture as we did not believe we needed as much inflation protection in our portfolios going forward. We also reduced our cash exposure and increased our overall global equities exposure due to improving economic fundamentals. This reduced our underweight to global equities, but maintained our overall defensive positioning.

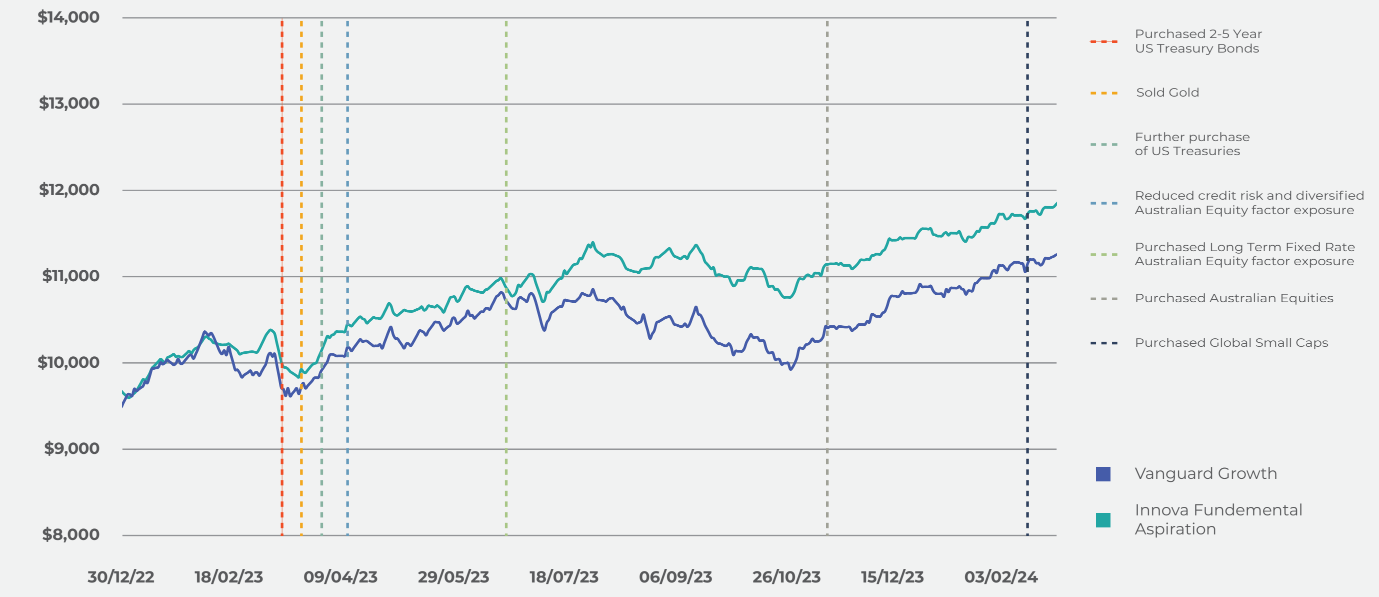
- Purchased global quality small caps and sold global agriculture.
- Increased our overall global equity position, though maintained our defensive positioning with an underweight to global equities.

Performance

	1 MTH	3 MTH	6 MTH	1 YR	3YR	5YR
CONSERVATIVE/ LOW RISK BUCKET						
Innova Lifestyle Preservation Portfolio - Fundamental	1.69%	2.26%	5.58%	6.00%	2.60%	2.46%
Innova Lifestyle Preservation Portfolio - Flagship	**1.69%**	**2.33%**	**5.63%**	**6.23%**	**2.85%**	**2.60%**
Target Cash Rate +1.5%	0.50%	1.48%	2.97%	5.86%	3.69%	3.05%
BALANCED/MEDIUM RISK BUCKET						
Innova Wealth Creation Portfolio - Fundamental	**2.72%**	**4.87%**	**9.55%**	**11.06%**	**5.88%**	**5.86%**
Innova Wealth Creation Portfolio - Flagship	**2.75%**	**5.02%**	**9.93%**	**11.73%**	**6.00%**	**6.11%**
Target Cash Rate +3%	0.63%	1.85%	3.73%	7.42%	5.22%	4.57%
GROWTH/ HIGH RISK BUCKET						
Innova Aspiration Portfolio - Fundamental	**3.29%**	**6.07%**	**11.26%**	**13.06%**	**7.32%**	**7.59%**
Innova Aspiration Portfolio - Flagship	**3.28%**	**6.10%**	**11.15%**	**13.27%**	**7.09%**	**7.84%**
Target Cash Rate +5%	0.79%	2.34%	4.74%	9.51%	7.27%	6.60%

Portfolio changes PREVIOUS 12 MONTHS

INNOVA ACTIVE RISK MANAGEMENT: INNOVA ASPIRATION VERSUS VANGUARD GROWTH



TRADE	SUMMARY
16/11/2023 Australian Equities (Buy) & Credit and Cash (Sell)	Australian Equities were looking more attractive with better forecast short- and long-term returns, given their poor performance this year. Our large allocation to domestic floating rate credit had performed extremely well and our model suggested selling this less attractively priced asset to buy the more attractively priced Australian Equities. Simply put, we were selling high (credit) and buying low (Australian Equities). This was to be funded with our overweight to cash, as we were waiting for an opportunity to deploy this into attractively priced growth assets
23/06/2023 Long term fixed rate Aus Government Bonds (Buy) & Global Equities & credit (Sell)	Amid a worsening economic outlook, we held reservations about the pricing of equities, which did not adequately account for the elevated risk level of potential future earnings. In light of this, we made the decision to decrease our global equity exposure and instead allocate to long-term fixed-rate Australian Government Bonds. These bonds had reached more appealing levels, offering an opportunity to strengthen our hedge against potential equity market risks. Additionally, we opted to further reduce our credit exposure. Although this position was attractively priced, we recognised that it was unlikely to generate gains in the event of equity market declines.
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.
31/03/2023 US Treasuries (Buy) & Relative Value (Sell) / South Korea (Buy) & Japan (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. We also believe that South Korea presents a better opportunity for growth than Japan, so we'll be selling our Japan exposure to focus on South Korea's promising risk/return profile.

TRADE	SUMMARY
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 anticipated continued volatility in equity and bond markets.
13/03/2023 2-5 Year US Treasury Bonds (Buy) & Australian 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 had the potential for significant capital gains in the event of a stock market decline. To fund this investment, we sold Australian Government Bonds as we believed a US-centric allocation would offer a better return profile in the future.

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