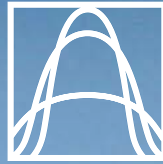


INNOVA
ASSET MANAGEMENT

QUARTER THREE 2024
CFS FIRSTCHOICE

— MARKET OUTLOOK REPORT

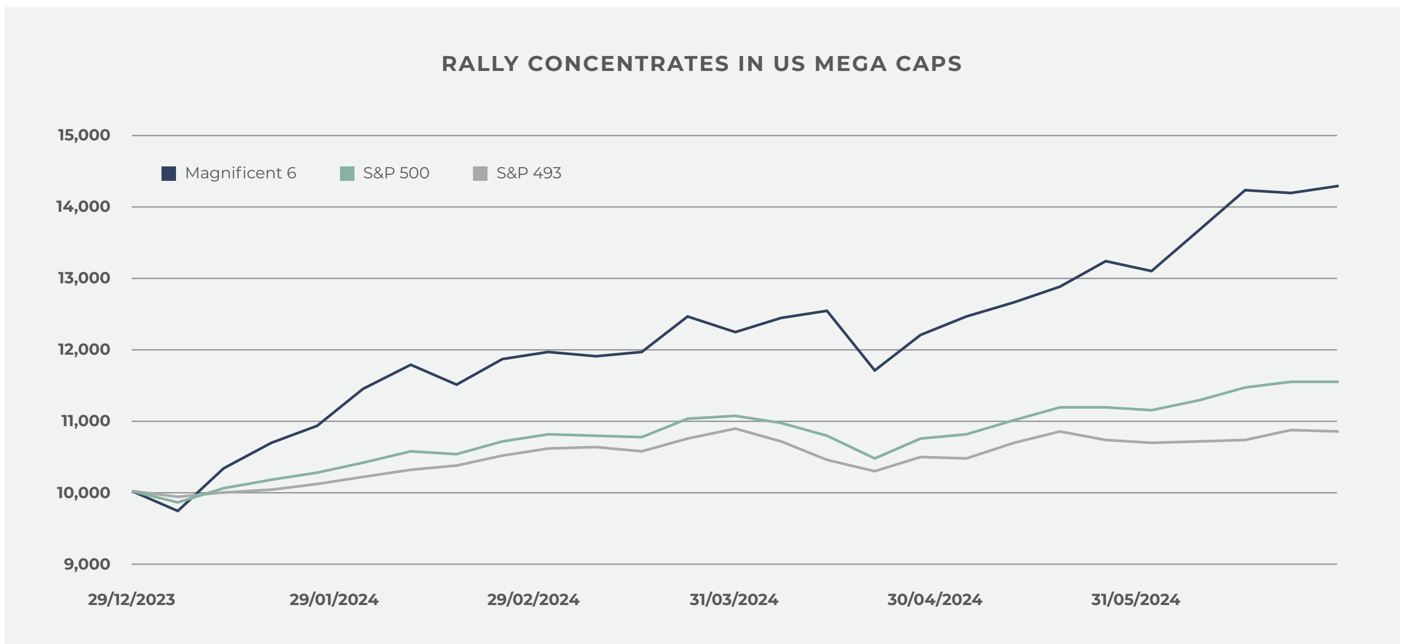
Key Takeaways

- The US equity market rally extended in Q2, as did much of the world, but Australia, small companies, Value equities, and Japan lagged.
- US Mega-cap companies, excluding Tesla, rose, but this rally was driven more by a valuation increase than earnings, posing a risk to markets if earnings miss expectations or if there's a downturn in US GDP.
- Opportunities exist within both the US and global undervalued equity markets.
- We still think there will be a cyclical rebound, but there are some low probability risks that we are positioning portfolios for, just in case. These risks include a growth shock, inflation shock, and market correction.

What's happened in markets

Quarter two of 2024 witnessed a continuation of the US equity market rally, which helped lift global indices like the MSCI All Country World Index (ACWI). However, certain markets such as Australia, small companies, Value equities, and Japan did not perform as well. Europe saw modest gains, as did UK Equities, while Emerging Markets (EM) and Asia also had positive performances, despite the Shanghai Composite's fall and South Korea's underperformance compared to its Asian counterparts.

The rally in US Mega-cap companies' prices, now known as the 'Magnificent 6' after Tesla fell out of favour, was significant. However, this rally was largely attributed to a valuation increase rather than earnings growth, which indicates that the market expects these earnings upgrades to continue for some time. This presents a risk to markets, as any misses on earnings or an unexpected downturn in US GDP could have catastrophic effects on these richly valued businesses.



Source: Bloomberg and Innova Asset Management

Innova house view

- We are cautiously optimistic, with the US making strides towards its 2% inflation target and the Federal Reserve potentially cutting rates in the latter half of 2024, facilitating a modest cyclical recovery.
- However, the labour market shows signs of weakening momentum—though not yet indicative of an imminent recession.
- In Australia, persistent inflation in the service sectors tempers the prospect of reducing interest rates. While futures pricing hints at potential rate hikes due to persistent inflation, we do not anticipate the RBA will raise rates.
- 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.

- Outside of our base case, we continue to believe there are three other potential scenarios for us to be aware of and we are including hedges in our portfolios for these:
  - A growth shock
  - An inflation shock (which hasn't been factored in)
  - A fall in equity prices
- However, we think the three other scenarios outside of our base case have a low probability of occurring, so our main theme continues to be investing in fairly priced assets, with a slight underweight to equities.

Potential scenarios and positioning:

CYCLICAL REBOUND (PRIMARY OR BASE CASE)	GROWTH SHOCK	INFLATION SHOCK	VALUATION DOWNGRADE
• Rates to remain sticky and higher for longer as economy stays strong • Recent market leaders unlikely to be future market leaders • Pro-cyclical sectors, regions and styles should do well • Currently these are fairly priced, the cyclical rebound hasn't been priced in as a goldilocks scenario • They are inherently less interest-rate sensitive	• GDP unexpectedly turns negative, we see a recession • Underweight equities, hold equities with downside protection • Long Government bonds should do well	• It's not inflation, but unexpected inflation that shocks markets and causes higher volatility • Low probability scenario, but hold assets with little interest rate sensitivity (e.g. FRNs, Value equities) • Alternatives can be invaluable in this environment (trend following and defensive alts)	• Market falls under its own weight • Same positioning as Growth Shock • Underweight equities, hold equities with downside protection • Long Government bonds should do well

How we're positioning our portfolios

SUB ASSET CLASS	12 MONTH RETURN	LONG TERM RETURN FORECAST	CURRENT POSITIONING
Asia Pacific ex Japan Equity	12.0%	6.16%	Overweight
Global Value Equity	10.8%	5.89%	Overweight
Japanese Equity	19.6%	2.72%	Neutral Weight
Global Equity	19.8%	2.51%	Underweight
US equities	24.7%	1.14%	Underweight
Global Quality	28.9%	0.06%	Underweight
Australian Equity	12.6%	6.55%	Neutral Weight
Global Infrastructure	6.1%	4.66%	Underweight
Australian REITS	18.0%	2.81%	Underweight
Domestic Credit	5.6%	4.96%	Overweight
Domestic Treasury	2.3%	4.50%	Neutral Weight
Global Treasury	1.2%	4.40%	Neutral Weight
Cash	4.35%	4.37%	Underweight

- We remain underweight equities in general, overweight fixed income and underweight real assets.
- Within fixed income we now have a more balanced position between fixed rate Government bonds and floating rate credit.
- Value equities and relative value equity positions remain a key overweight.

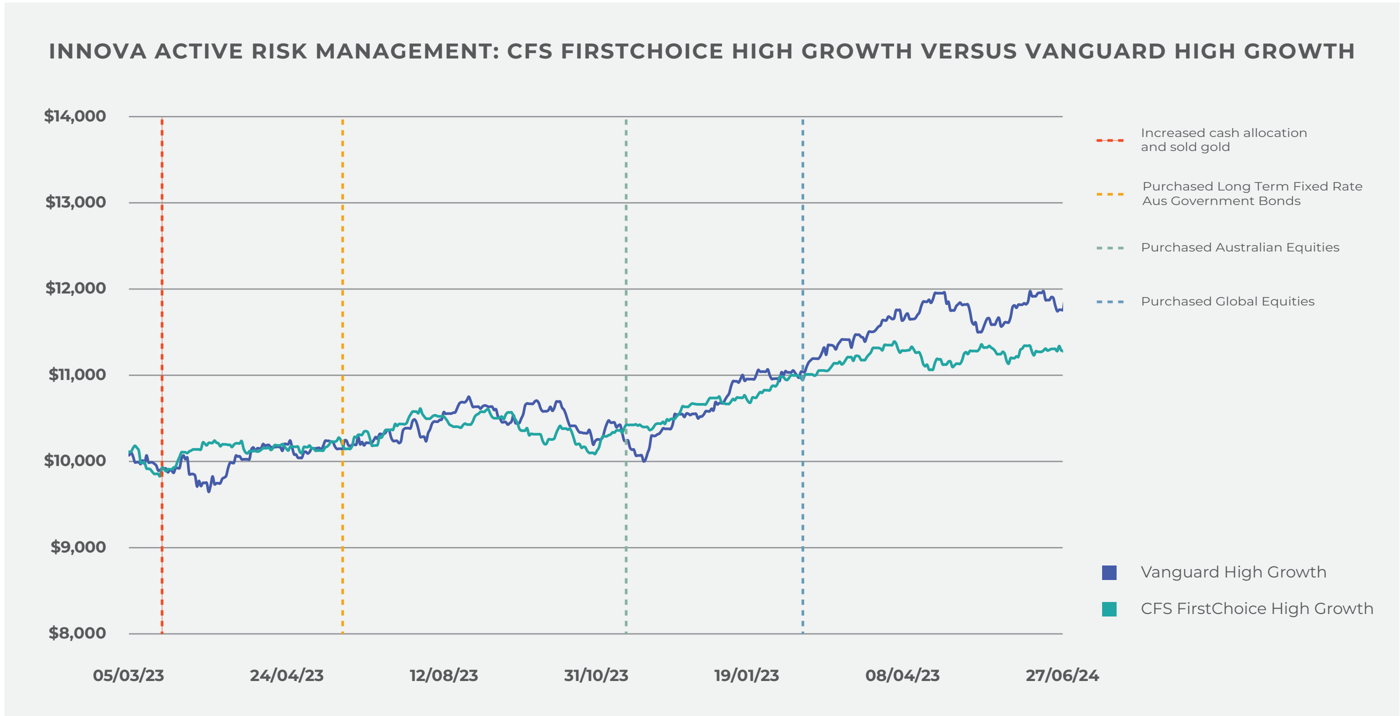
Recent portfolio changes

TRADE	SUMMARY
08/07/2024 Australian Index (buy) & Australian Alpha (sell)	We had observed several cyclical headwinds in relation to the domestic equity market (services inflation remained sticky, real GDP per capita was signalling a recession and forward earnings had declined while prices were still high). For these reasons we preferred quality and defensive exposures domestically. We executed a manager switch to reduce exposure to the discretionary spending sector, though we wanted to maintain a hedge against our base case for domestic equities (underweight cyclicals and overweight defensives) and therefore allocated to the Australian Equity Index to retain exposure to cyclical sectors while bringing down the overall cost of the portfolio.

Performance

	1 MTH	3 MTH	6 MTH	1 YR
CONSERVATIVE				
Innova Active Conservative Portfolio - FC Wholesale Pension	**0.39%**	**0.14%**	**2.47%**	**6.09%**
Innova Active Conservative Portfolio - FC Wholesale Super	**0.35%**	**0.13%**	**2.24%**	**5.66%**
Morningstar Benchmark	0.59%	0.00%	2.05%	5.50%
MODERATELY CONSERVATIVE				
Innova Active Moderately Conservative Portfolio - FC Wholesale Pension	**0.39%**	**-0.33%**	**3.25%**	**7.41%**
Innova Active Moderately Conservative Portfolio - FC Wholesale Super	**0.35%**	**-0.27%**	**3.02%**	**6.98%**
Morningstar Benchmark	0.61%	-0.20%	2.74%	6.40%
BALANCED				
Innova Active Balanced Portfolio - FC Wholesale Pension	**0.45%**	**-0.76%**	**3.87%**	**8.34%**
Innova Active Balanced Portfolio - FC Wholesale Super	**0.42%**	**-0.63%**	**3.66%**	**7.94%**
Morningstar Benchmark	0.71%	-0.38%	4.21%	8.47%
GROWTH				
Innova Active Growth Portfolio - FC Wholesale Pension	**0.44%**	**-1.00%**	**4.64%**	**9.34%**
Innova Active Growth Portfolio - FC Wholesale Super	**0.41%**	**-0.83%**	**4.39%**	**8.94%**
Morningstar Benchmark	0.86%	-0.56%	5.36%	10.11%
HIGH GROWTH				
Innova Active High Growth Portfolio - FC Wholesale Pension	**0.49%**	**-1.17%**	**4.92%**	**9.83%**
Innova Active High Growth Portfolio - FC Wholesale Super	**0.45%**	**-0.98%**	**4.66%**	**9.43%**
Morningstar Benchmark	1.02%	-0.45%	7.63%	13.47%

Portfolio changes PREVIOUS 12 MONTHS



TRADE	SUMMARY
15/02/2024 Global Equities (Buy) & Cash (Sell)	Based on our leading economic indicators, economic fundamentals had improved, and inflation was trending lower, therefore we decided to increase our allocation to global equities, using a low cost index option to increase our overall global equity market exposure. This was funded from excess cash that had been kept aside for tactical investment opportunities.
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
26/06/2023 Long term fixed rate AUS government Bonds (Buy) & Credit (Sell)	After an extended fixed income sector review, we determined that long term fixed rate Australian Government Bonds had moved to attractive levels and offered an opportunity to hedge equity market risk in the face of tightening economic fundamentals. This was funded through a reduction in Australian floating rate credit. This was because it was unlikely to appreciate in the event of equity market weakness, even though it still appeared attractively priced at the time.
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.

Important Information

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