INNOVA ASSET MANAGEMENT

QUARTER THREE 2024
RISK DEFINED

— MARKET OUTLOOK REPORT

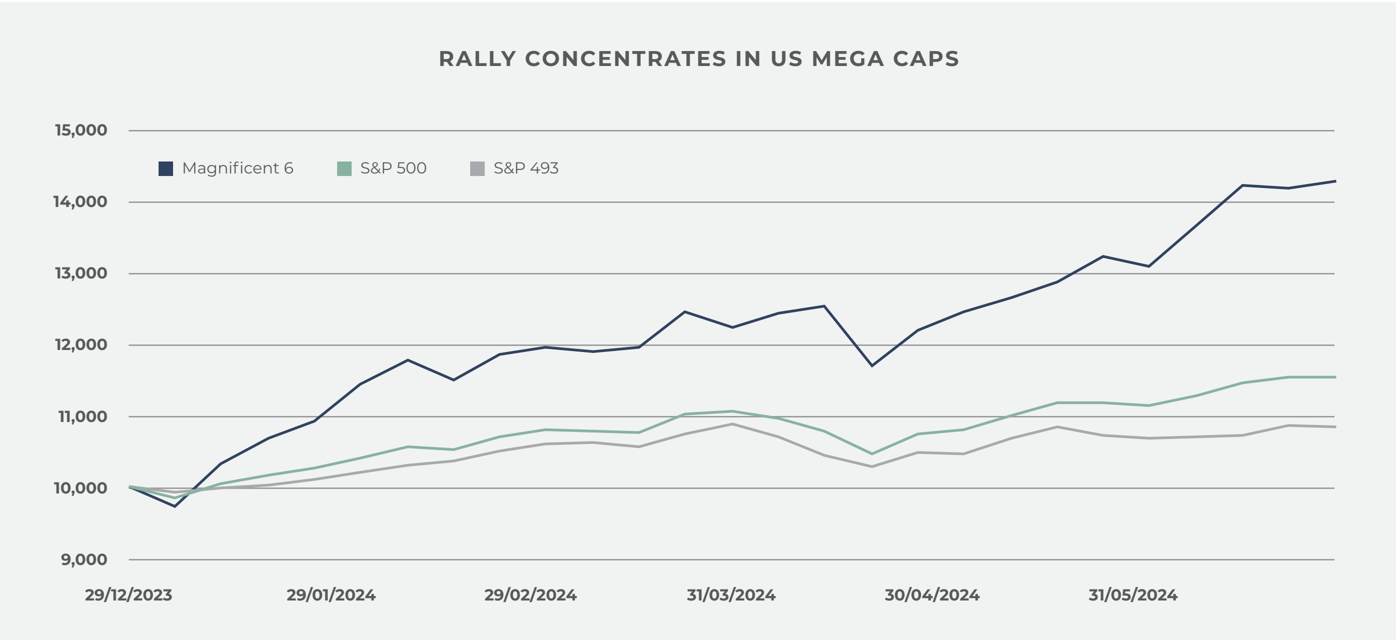
Key Takeaways

- 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 shifted our portfolios to take advantage of the undervalued Quality small caps, Asia, EM, and the UK.
- 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 performance, 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
Korean Equity	9.7%	8.64%	Overweight
UK Equity	12.7%	8.28%	Overweight
Emerging Market Equity	11.2%	7.18%	Overweight
Quality small cap Equity	18.9%	6.31%	Overweight
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.
- UK equities, via the FTSE100 ETF, continue to demonstrate outsized forecast returns from our systematic outputs
- 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.

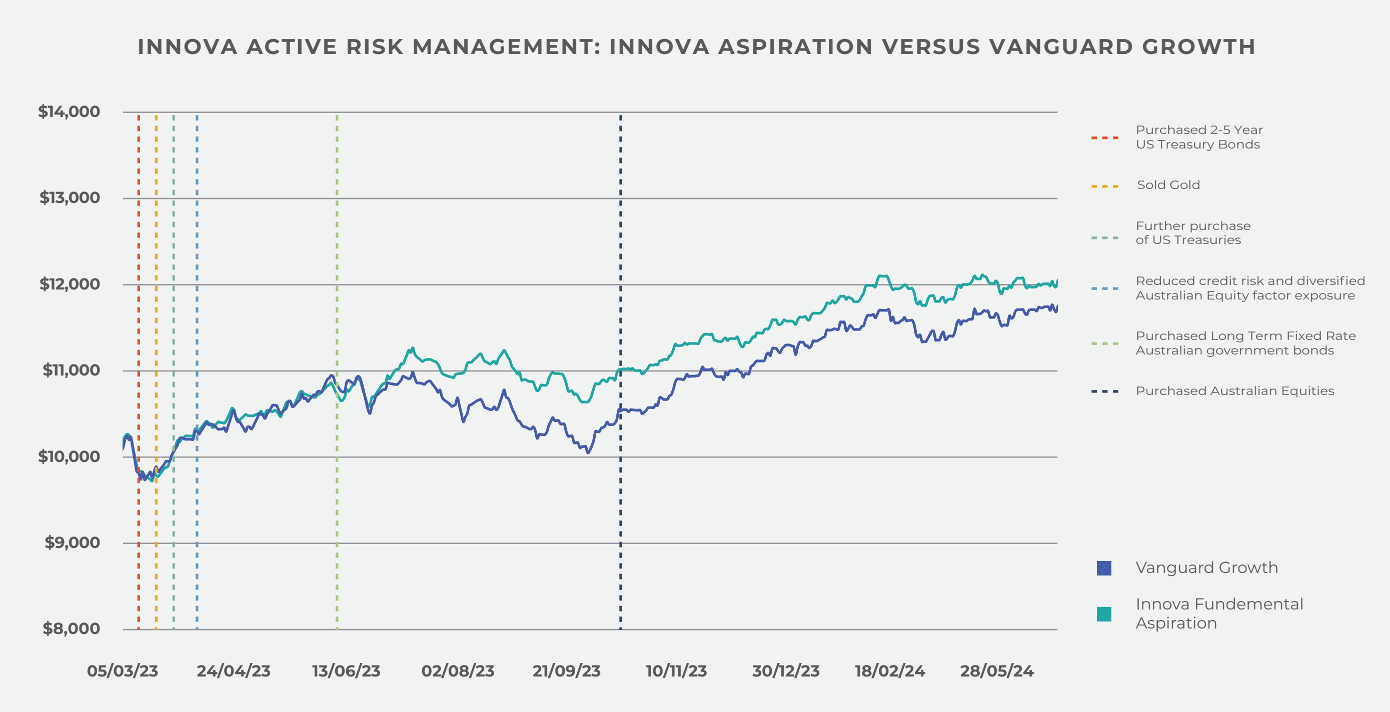
Recent portfolio changes

TRADE	SUMMARY
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	3YR	5YR
CONSERVATIVE/ LOW RISK BUCKET						
Innova Lifestyle Preservation Portfolio - Fundamental	**0.61%**	**0.34%**	**2.60%**	**6.22%**	**2.07%**	**2.22%**
Innova Lifestyle Preservation Portfolio - Flagship	**0.43%**	**0.06%**	**2.39%**	**5.91%**	**2.24%**	**2.30%**
Target Cash Rate +1.5%	0.49%	1.48%	2.98%	6.00%	4.06%	3.20%
BALANCED/MEDIUM RISK BUCKET						
Innova Wealth Creation Portfolio - Fundamental	**0.65%**	**-0.37%**	**4.48%**	**9.21%**	**4.15%**	**5.19%**
Innova Wealth Creation Portfolio - Flagship	**0.39%**	**-1.08%**	**3.88%**	**8.92%**	**4.04%**	**5.28%**
Target Cash Rate +3%	0.61%	1.85%	3.74%	7.57%	5.60%	4.73%
GROWTH/ HIGH RISK BUCKET						
Innova Aspiration Portfolio - Fundamental	**0.62%**	**-0.67%**	**5.37%**	**10.39%**	**4.95%**	**6.66%**
Innova Aspiration Portfolio - Flagship	**0.23%**	**-1.54%**	**4.47%**	**9.53%**	**4.51%**	**6.79%**
Target Cash Rate +5%	0.77%	2.34%	4.74%	9.66%	7.65%	6.76%

Portfolio changes PREVIOUS 12 MONTHS



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.
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.

TRADE	SUMMARY
31/03/2023 US Treasuries (Buy) & Relative Value (Sell) / South Korea (Buy) & Japan (Sell)	The bond market had been unstable lately and other investment options were now offering higher returns, making less traditional fixed income options less attractive. As a result, we planned to invest more in US Government bonds and less in other fixed income strategies. We also believed that South Korea presented a better opportunity for growth than Japan, so we sold our Japan exposure to focus on South Korea's promising risk/return profile.
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.