



INNOVA
ASSET MANAGEMENT

QUARTER FOUR 2024
RISK DEFINED

— MARKET OUTLOOK REPORT

Key Takeaways

- **Australian Market Outlook:** Despite weak economic growth and declining earnings, the Australian market continues to rally, though we believe a defensive stance is prudent given concerns about the RBA's stance and market valuations.
- **Global Positioning:** Globally, maintaining a long-term, valuation-driven strategy has historically outperformed. We favour value and size factors, which are well-positioned for a reflationary regime, particularly in sectors like small-cap and cyclical stocks.
- **Monetary Policy and Economic Conditions:** The U.S. economy shows resilience with stable labour markets, supported by government spending and rate cuts. We expect a soft landing, led by cyclical and small-cap stocks, and a weakening U.S. dollar, benefiting emerging markets.
- **China's Market Surge:** China's stock market rally, driven by government support, depends on further fiscal stimulus to sustain momentum, particularly in addressing the property market downturn.
- **Portfolio Adjustments:** We have adjusted our portfolio to maintain a neutral equity weight, with a mild overweight in fixed income. We emphasise value equities, defensive positioning in Australia, and have reallocated from Asia to pro-cyclical U.S. exposure, particularly through the S&P500 equal weight ETF (QUS).

What's happened in markets

The third quarter was highly volatile, with Japan's Nikkei index experiencing a sharp decline of roughly 25% from late July to early August. However, it has since rebounded by around 25%, though it is still hovering near its all-time highs. Concerns about Labour market weakness emerged during the August Yen crisis, but part of the increase in unemployment was due to a rise in the labour force from immigration. Underneath the headline data, labour markets continue to show signs of softening, with further downward revisions expected.

Germany's economy has struggled since the start of the Russia-Ukraine war, losing access to the cheap energy that once powered its manufacturing sector. The country's growth has been sluggish, and economic surprises remain negative. While Germany still has a skilled workforce and high living standards, its economic outlook is uncertain, with GDP lagging behind pre-COVID trends. Australia, on the other hand, faces its own challenges. The Reserve Bank of Australia (RBA) is stuck between a weak economy and stubborn inflation, with the share market seemingly defying economic conditions by reaching new highs despite slowing GDP growth and declining corporate earnings.

Innova house view

- The Australian market continues to rally despite declining earnings and weak economic growth, largely due to faith in potential monetary policy loosening. However, Australian banks remain expensive relative to global peers, despite weaker returns.
- Globally, sticking to a long-term, valuation-driven strategy has historically led to outperformance. Innova remains committed to long-term positioning while refining short-term signals to enhance forecasts.
- Factor valuations for quality and growth are stretched, and cheaper factors like value and size are preferred, especially in a reflationary environment where value typically outperforms.
- The U.S. is experiencing a mild slowing in labour markets, but ongoing government spending and rate-cutting cycle suggest a soft landing with cyclical recovery in small-cap and undervalued stocks.
- China's stock market has surged due to supportive government policies, though the rally's sustainability depends on further fiscal stimulus to address the property market and boost consumer spending.

Potential scenarios and positioning:

| CYCLICAL REBOUND (PRIMARY OR BASE CASE) | GROWTH SHOCK | INFLATION SHOCK | VALUATION DOWNGRADE |
|---|---|---|---|
| <ul style="list-style-type: none"> 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 | <ul style="list-style-type: none"> GDP unexpectedly turns negative, we see a recession Underweight equities, hold equities with downside protection Long Government bonds should do well | <ul style="list-style-type: none"> 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) | <ul style="list-style-type: none"> 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 |

- The portfolio remains neutral on equities, with positions in QSML and QUS, while maintaining a mild overweight to fixed income, balanced between long-duration government bonds and floating rate credit.
- Value equities and relative value positions are key overweights, with a focus on cyclical sectors globally, but defensives in Australia due to concerns about its economy and earnings outlook.
- VLUE, QSML, UK equities (FTSE100 ETF), QUS are showing strong forecast returns and superior earnings yields based on systematic analysis.
- The portfolio has shifted toward Quality small caps for their attractive valuation and similar earnings growth potential compared to large caps.
- Allocations to Asia were reduced due to concerns about China, with a corresponding increase in pro-cyclical exposure to the S&P500 equal weight ETF (QUS).

Recent portfolio changes

| TRADE | SUMMARY |
|---|---|
| 14/08/2024 Asian Equities (Sell) & US Equities (Buy) | We previously maintained a significant underweight position in US equities and an overweight position in Asia. However, given our base case of economic resilience and anticipation of a rebound in the US market, it was prudent to increase our allocation to US equities. We achieved this by investing in the equal-weighted index, thereby avoiding additional exposure to the costly US mega-cap stocks. This reallocation was funded by reducing our overweight position in Asia. Investing in the equal-weighted index allowed us to capitalise on the decline in US equity prices and the increased valuation gap relative to the mega caps. |

Performance

| | 1 MTH | 3 MTH | 6 MTH | 1 YR | 3YR | 5YR |
|---|-------|-------|-------|--------|-------|-------|
| CONSERVATIVE/ LOW RISK BUCKET | | | | | | |
| Innova Lifestyle Preservation Portfolio - Fundamental | 0.79% | 2.96% | 3.31% | 9.07% | 2.91% | 2.57% |
| Innova Lifestyle Preservation Portfolio - Flagship | 0.57% | 2.51% | 2.57% | 8.35% | 2.84% | 2.57% |
| Target Cash Rate +1.5% | 0.49% | 1.50% | 3.00% | 6.06% | 4.44% | 3.38% |
| BALANCED/MEDIUM RISK BUCKET | | | | | | |
| Innova Wealth Creation Portfolio - Fundamental | 1.13% | 4.05% | 3.66% | 13.57% | 5.00% | 5.58% |
| Innova Wealth Creation Portfolio - Flagship | 0.80% | 3.50% | 2.38% | 12.55% | 4.51% | 5.58% |
| Target Cash Rate +3% | 0.61% | 1.87% | 3.76% | 7.63% | 5.98% | 4.90% |
| GROWTH/ HIGH RISK BUCKET | | | | | | |
| Innova Aspiration Portfolio - Fundamental | 1.37% | 4.57% | 3.88% | 15.57% | 5.82% | 7.03% |
| Innova Aspiration Portfolio - Flagship | 0.87% | 3.62% | 2.03% | 13.40% | 4.82% | 7.05% |
| Target Cash Rate +5% | 0.77% | 2.37% | 4.77% | 9.73% | 8.04% | 6.94% |



Portfolio changes PREVIOUS 12 MONTHS

| TRADE | SUMMARY |
|--|---|
| <p>08/07/2024 Australian Index (buy) & Australian Alpha (sell)</p> | <p>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.</p> |
| <p>15/02/2024 Quality small caps (buy) & Global Agriculture (sell)</p> | <p>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.</p> |
| <p>16/11/2023 Australian Equities (Buy) & Credit and Cash (Sell)</p> | <p>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</p> |
| <p>23/06/2023 Long term fixed rate Aus Government Bonds (Buy) & Global Equities & credit (Sell)</p> | <p>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.</p> |

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