2023 Year in Review & Outlook for 2024

December 2023

Summary

From an economic and financial markets perspective, 2023 turned out much better than many had expected. Notwithstanding the negativity that was pervasive entering the year, equity markets ultimately delivered strong returns.

- In particular, global equity markets delivered very strong returns relative to Australian equities, as the large weighting of the Australian market to Financials and Materials weighed on performance. This dispersion of returns from time to time underlines the importance of portfolios having diversified equity exposures beyond our shores.
- Inflation and its implications for interest rates were the big talking points in 2022 and so it was again in 2023. With inflation declining in Australia and the US, markets which have been constantly (and wrongly) looking for a "Fed Pivot" may get their wish in 2024 as the latest Federal Reserve dot plot implies an expectation of three to four 0.25% interest rate decreases over the course of the year.
- Looking forward, the potential for interest rate cuts is clearly more positive for equity markets than negative. We do however note that changing expectations are rapidly priced in by equity markets, with the ASX200 now sitting less than 3% below its all-time high, while the S&P500 is just 2% off its all-time high, following its ~13% rise since the start of November.
- In *Other Things*, we discuss some of the topics that we have been thinking about recently, including Charlie Munger, Private Credit, Cryptocurrency and the Aussie dollar's 40th birthday.

Thank you again for entrusting the management of your portfolios to the Entrust team. We wish you and your families a very happy Christmas and New Year. Should you have any questions on your portfolio or investment markets in general, please give us a call.

Kind Regards

Rowan Jones

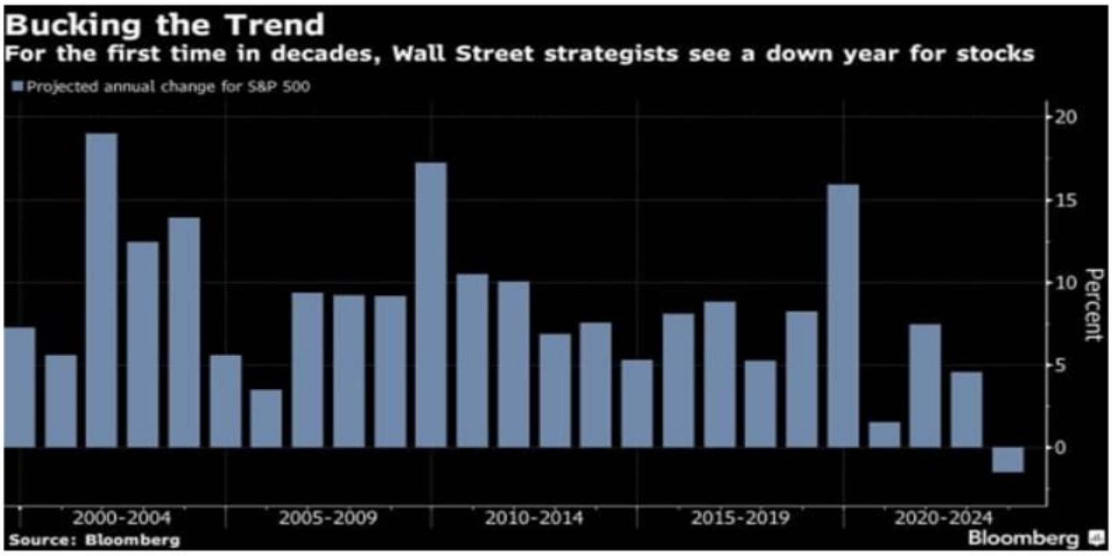
Head of Entrust Wealth Management

Better Than Expected

At the end of 2022, a well-known, high-profile economist and media commentator exhorted domestic investors to *"Prepare for an economic bushfire in 2023",* as part of a scenario in which he envisaged mass job losses and waves of corporate defaults as part of a global recession.

This bearishness was certainly not restricted to the domestic market. As we noted in our *June 2023 Quarterly Commentary*, for the first time since the turn of the century, Wall Street Strategist predictions were for the S&P500 to deliver a negative return for the year ahead ***(Chart 1)***; the result, as at 15th December 2023: a gain of 22.9%.

Chart 1 – Wall Street expectations entering 2023



Source: Charlie Bilello

In our *2022 Year in Review & Outlook for 2023* we discussed the sceptical eye with which we view market (and other) forecasts.

To be clear, our cynicism around forecasts doesn't preclude us having an opinion on the economy, share markets, interest rates, etc. Rather, we recognise the need to allow for uncertainties and surprises when we come to managing client portfolios.

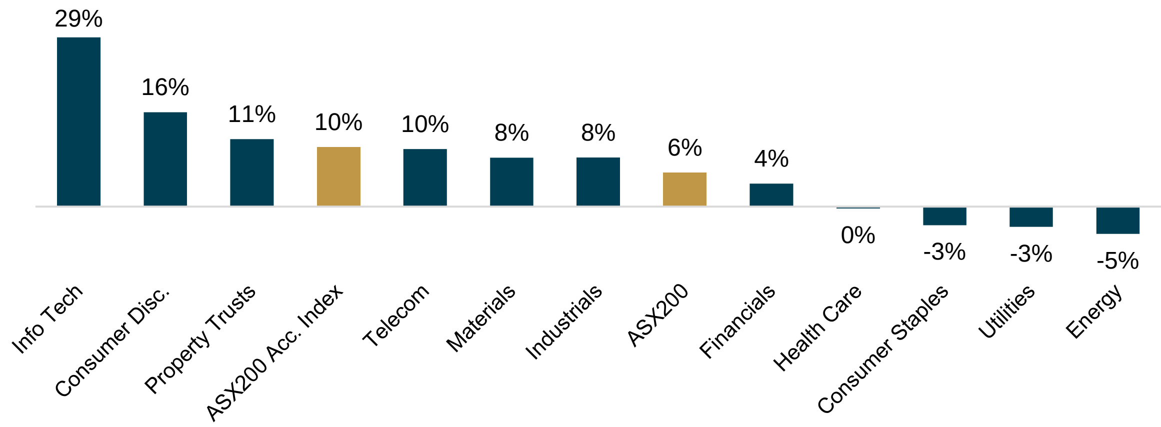
Notwithstanding the gloomy outlooks coming from many corners, throughout 2023 we maintained an exposure to growth assets, such as equities, albeit at a slightly underweight level, reflective of the uncertainties in the economy, coupled with increasing interest rates providing opportunities to generate reasonable returns from less risky assets (e.g., Fixed interest, Government Bonds and Bank Hybrids).

Equity Market Performance

The ASX200 Accumulation Index (i.e., inclusive of dividends) provided a calendar year return of 10.1% as at 15th December 2023. ***Chart 2*** shows the performance of the ASX200 component sectors, with Technology stocks leading the way, while Energy was the laggard. Proving that valuations do matter, one of the more maligned sectors at the start of the year, Consumer Discretionary, performed very well, while the perceived defensiveness and safety (and high prices) of Consumer Staples delivered a negative return.

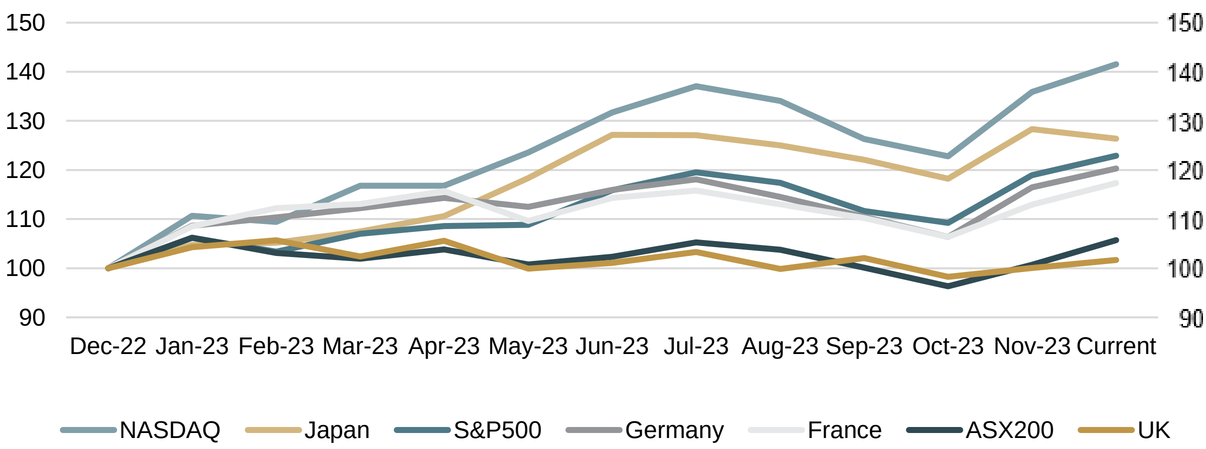
Major global equity indices performed significantly better than the Australian market (***Chart 3***). We have previously discussed (*June 2023 Quarterly Commentary*) how the large weighting of Australian equities to Financials (Banks) and Materials (Resources) can lead to a wide dispersion of returns (positive and negative) from time to time between Aussie and global markets. This again underlines the importance of portfolios having equity exposures diversified beyond our shores.

Chart 2 – 2023 ASX200 returns by sector



Source: Entrust Wealth Management, IRESS

Chart 3 – Global Equity Market Returns



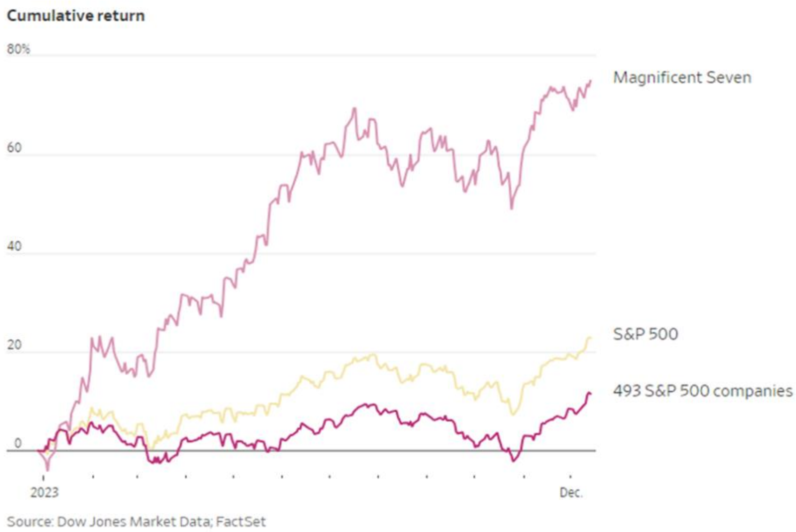
Source: Entrust Wealth Management, IRESS

Year of the Mega-Cap

One area that can't go without comment has been the exceptional performance of the so-called "Magnificent Seven", comprising Apple, Microsoft, Alphabet (parent of Google), Amazon, NVIDIA, Meta Platforms (Facebook) and Tesla.

Chart 4 shows that year to date, as a group the Magnificent Seven stocks are up 75%. Absent these stocks, the "S&P493" is up 12%, well below the headline S&P500 return of 23%.

Chart 4 – The Magnificent Seven v S&P493



Source: Charlie Bilello

Outlook – 2024 and Beyond

Inflation and its implications for interest rates were the big talking points in 2022, and so it was again in 2023.

Over the course of 2023, the annual rate of inflation has moderated in Australia, coming down from a peak of 7.8% in December 2022 to a monthly annualised rate of 4.9% at October 2023, still well above the RBA's target rate of 2-3%.

In the United States, the annual change in the US Fed's preferred inflation measure, Core PCE (which excludes volatile energy and food prices) declined to 3.5% in October from a peak of 5.1% in September 2022. Like Australia, this remains well above the target inflation rate in the US of 2.0%.

Fed Pivot – No, no, no, maybe…

One constant over the last year, and something we discussed in our *2022 Year in Review & Outlook for 2023*, was the market narrative of a "Fed Pivot" i.e., the expectation (hope) that the US Fed will cease its interest rate rises and indeed start to ease rates. In contrast, what actually occurred were interest rates that rose much higher than markets had expected *(Chart 5)*. **As *Chart 5*** also shows, markets (outside of Japan) are now expecting quite significant rate cuts in 2024.

Chart 5 – Interest Rate Cut Expectations

Change in central bank rates, in basis points

Central bank	What markets expected for 2023	What actually happened in 2023	What markets expect for 2024
US	66	150	-110
Euro zone	141	250	-133
Japan	22	0	25
UK	159	225	-74
Canada	31	125	-106
Australia	79	150	-31
New Zealand	77	125	-55
Switzerland	86	125	-61
Denmark	136	235	-119
Norway	10	175	-101
Sweden	72	150	-114

Source: Bloomberg
Market expectations are derived from swap rates as of Dec. 1, 2022, and Dec. 7, 2023

Source: Matt Levine

It does however look like the market may finally get its wish.

At the recent December meeting of the Federal Reserve the target range for the federal funds rate was kept steady at 5.25-5.50%. However, and more importantly for markets, the updated "dot plot" which shows Federal Reserve members expectations for future interest rate moves, showed the median rate expected by the end of 2024 to be 4.60%; suggesting between three and four 0.25% rate cuts over the course of the year.

The expectation for rate cuts has been largely built on the belief that inflation is "under control" as it continues declining back toward central bank target levels. While these recent reductions in inflation are certainly welcome, we should not get too complacent; as Oaktree Co-Chairman, Howard Marks, notes *"it's important to remember that inflation is mysterious, unpredictable, and challenging to manage."*

What does it all mean?

While there is undoubtedly a glow of positivity in the market given the potential for interest rate cuts in 2024 and what it *may* mean for equity markets, we note that not all observers are getting carried away. At a recent *New York Times* event, Jamie Dimon, CEO of JP Morgan and one of the most respected figures in global finance, explained his cautiousness on the economy, emanating largely from the fact that we are in a period that hasn't been seen before, that being: the strength of the economy is predominantly due to prior (pandemic-induced) monetary stimulation in part, via *QE* (*Quantitative Easing),* which is now being reversed in part through *QT (Quantitative Tightening)*:

"Let me just caution you on the economy. When people look at the current economy and things are going good, stocks are up. And we've had a little bit of drugs injected directly into our system, called fiscal stimulation – the largest we've ever had in peacetime. And QE – the largest monetary stimulation. Two different things, different effects, but they are drugs running through the system. And they create this kind of sugar high, and we're in a sugar high. I don't know if it's going to end in a soft landing or something like that. But people say, well corporate profits are up, this is up. Yeah, corporate profits are up because people are spending a lot of money. Where did they get the money? The government gave it to them. Well, of course profits are up. When they stop spending money, profits will go down. So, I'm a little worried that we're in that little bit of a sugar high and we don't understand it...

… We've never had QT before. I think it may bite more than other people [think]. You're going to see it in volatile markets. You've seen very volatile markets. Now, most don't care about volatile markets unless it starts to affect the economy, which it might. So, I'm quite cautious about the economy."

Outlook & Portfolio Positioning

Over the course of 2023 we have gradually increased portfolio exposure to risk assets while maintaining a relatively cautious stance overall. This approach has been driven by a combination of:

- the uncertain outlook over the period, and
- the fact that the rising interest rate environment has provided good opportunities in lower risk asset classes to generate levels of return suitable in constructing portfolios to meet client goals.

Looking forward, the potential for interest rate cuts is clearly more positive for equity markets than negative. We do however note that changing expectations are rapidly priced in by equity markets, with the ASX200 now sitting less than 3% below its all-time high, while the S&P500 is just 2% off its all-time high, following its ~13% rise since the start of November.

We do find it interesting that equity markets have reacted so rapidly and bullishly to rate cut expectations, given that rate cuts generally occur in reaction to a slowing economy.

If and when the Australian and global economies start to slow it will be interesting to observe whether or not investors retain the same level of enthusiasm for listed equities.

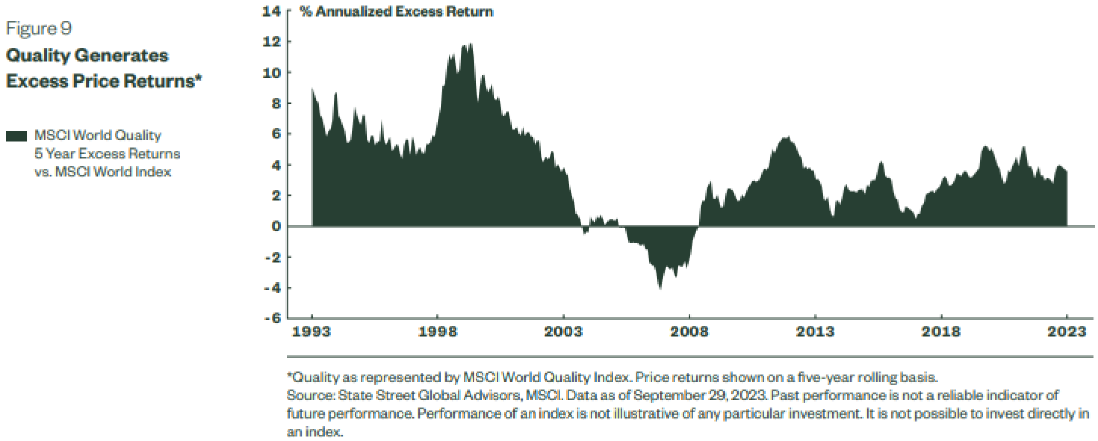
In any case, we think that these rapid market moves further underscore the case against trying to time markets as we discussed in our *2022 Year in Review & Outlook for 2023.*

In regard to individual asset classes:

- Opportunities remain for the generation of solid, low-risk returns from a range of income-based assets (e.g., Bank Hybrids, Government Bonds, Private Credit etc.).
- As discussed in our *September 2023 Quarterly Commentary*, where appropriate we will continue to add good quality, cash generative direct equity exposures when opportunities present.

As ***Chart 6*** shows, over time a portfolio of "quality" businesses (defined by attributes such as high return on equity, strong balance sheets, durable business models etc.) performs materially better than the broader indices. This is consistent with Warren Buffett's adage that *"time is the friend of the wonderful business, the enemy of the mediocre."*

Chart 6 – Quality wins over time



Source: State Street Global Advisors

Other Things

In this section we discuss some of the topics that we have been thinking about.

Charlie Munger (1924 – 2023)

Charles T. Munger, Berkshire Hathaway Vice Chairman and right-hand man to Warren Buffett, passed away on 28th November 2023, 34 days short of his 100th birthday.

Buffett has credited Munger with establishing the blueprint for Berkshire Hathaway's incredible and enduring success through transforming Buffett's investing style from buying "cigar butts" to buying businesses with strong long-term outlooks, counselling Buffett to *"Forget what you know about buying fair businesses at wonderful prices; instead, buy wonderful businesses at fair prices."*

Notwithstanding his intelligence, coupled with his exceptional success in life, Munger had a high respect and appreciation for the role of luck in both life and investing, noting that *"the records of people and companies that are outliers are always a mix of a reasonable amount of intelligence, hard work and a lot of luck."*

Wall Street Journal columnist, Jason Zweig, recalls Munger telling a story from his youth, which goes a long way to understanding Munger's appreciation for the role that luck can play *"In 1931, a boy and girl, both about seven years old, are playing on a swing set on N. 41st St. in Omaha. A stray dog appears and, without warning, charges. The children try to fight the dog off. Somehow, the boy is unscathed, but the dog bites the girl. She contracts rabies and, not long after, dies. The boy lives".* The boy's name: Charlie Munger.

Private Credit – The next bubble?

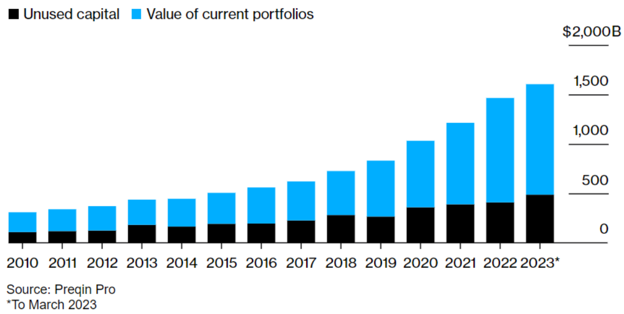
Private Credit, also known as *Private Debt* broadly encompasses credit provided to borrowers outside of the Banking system.

Typically, a Private Credit fund raises money from investors (including sovereign wealth funds, insurers, large superannuation funds and more recently, retail investors). The funds raised are then lent to borrowers. Assuming the borrowers meet their repayments as agreed, investors will receive a return on the funds they have invested.

Bloomberg explains that the Private Credit market started life by providing finance to private equity businesses and rapidly grew in the wake of the global financial crisis as banks facing increasing regulation pulled back from lending.

In recent years the size of the Private Credit market has increased materially; more than tripling from ~US$400bn in 2013 to over US$1,500bn by March 2023 (***Chart 7***).

Chart 7 – Global Private Credit Assets Under Management



Source: Bloomberg

Bloomberg reports that UBS Chairman, Colm Kelleher, has recently called the growth in private credit an asset bubble, while ECB Supervisory Board member Elizabeth McCaul has called for regulators to close supervisory "gaps" as the growing market could pose systemic risks.

Some reasons as to why concerns have been increasing include:

- Private Credit operates outside of the banking system and as such is largely free from oversight and capital requirements, thus increasing the risk of financial instability.
- The overall credit quality of the firms lent to is weaker than those that borrow traditional bank credit.
- The risk is being transferred from the banking system to investors including, retail investors, who may not understand what they are investing in.

At Entrust, over the last year, we have seen a marked increase in the number of Private Credit *"opportunities"* that have come across our desks.

Where appropriate, we have allocated a small portion of client portfolios to Private Credit.

These investments form part of diversified portfolios and have been made with Managers who have long track records of strong performance in the industry and with whom we have close relationships.

Cryptocurrency – Speculation returns

With animal spirits surging in some speculative pockets of financial markets, cryptocurrency (*"crypto"*), is again hitting the headlines.

The best known of the cryptocurrencies, Bitcoin, has risen nearly 150% during 2023 *(Chart 8)*, with sentiment becoming more bullish as a number of crypto-related ETFs and associated investment products await regulatory approval.

Chart 8 – Bitcoin – "to the moon"

Source: Google

Bitcoin was the first cryptocurrency created in 2009. Today, Forbes estimates that there are around 26,000 publicly traded cryptocurrencies.

Depending on the day, the combined market capitalisation of cryptocurrencies, according to CoinMarketCap is around US$1.55 trillion dollars (A$2.4 trillion) – an amount equivalent to the ~A$2.3 trillion total value attributed to all companies that comprise the ASX200.

Never say never, however we consider it highly unlikely that we would ever consider adding cryptocurrency exposure to client portfolios.

Our clear preference is to invest in productive assets (such as a selection of companies within the ASX200) rather than a speculative creation that, from what we can decipher, adds little value to society.

For those who would like an informative and entertaining background to the cryptocurrency industry, we highly recommend the recently released book *"Number Go Up"* by Bloomberg investigative reporter Zeke Faux.

The book title was inspired by Faux's attendance at a crypto conference where one of the speakers, Dan Held, a then executive with crypto exchange Kraken, declared *"Number go up technology is a very powerful piece of technology. It's the price. As the price goes higher, more people become aware of it, and buy it in anticipation of the price continuing to climb."*

This strikes us as more *"Ponzi scheme"* than *"Technology"*.

$AUD - Happy 40th!

The decision to float the Australian dollar was taken on 9th December 1983 by the Hawke Labor Government.

Firstlinks explains that prior to the float, in the early 1980s the value of the dollar was set via a "crawling peg" – meaning its value was pegged to other currencies weekly, and later daily, by a committee who announced the values at 9.30am each morning. If too much or too little money came into the country as a result of the rate the authorities had set, they adjusted it the next day, sometimes losing money to speculators who had bet they wouldn't be able to hold the rate they had set. Treasurer at the time, Paul Keating, said the float meant the speculators would be "speculating against themselves", rather than against the authorities.

We agree with Firstlinks assessment that the floating rate has served Australia well. In general, when the Australian economy has slowed or contracted the Australian dollar has fallen, making Australian exports cheaper in foreign markets.

When mining booms have sucked money into the country, the Australian dollar has climbed, spreading the benefit and fighting inflation by increasing the buying power of Australian dollars.

Chart 9 – Little Aussie Battler

Source: Firstlinks

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