End of Year Wrap-Up

December 2023

WATERSHED

Funds Management

Between 2 Screens End of Year Wrap-Up

*You can view the full video **here** with the following article summarising the key points and views from the team heading into 2024:*

Key Points:

- **The US was more resilient than expected –** Coming into 2023 we had been cautiously positioned on the expectation that economic growth globally would slow (but not crash). This has largely played out in Australia, China and Europe, but what has surprised us has been the ongoing strength of the US.
    - **International Share –** Despite sitting on ~19% cash, the Watershed International Share Portfolio finished 2023 up almost 30%, driven by positions in Technology stocks.
    - **Emerging Leaders –** looking forward we are now seeing attractive valuations in the small-mid caps sector, but are anticipating further earnings downgrades into 2024.
    - **Income -** We came into the start of the bond market sell off with zero market duration and progressively increased this over the year to just under 30% mainly through Australian Government Bonds and US Treasuries.
    - **International Share ETF –** exposures to Europe and Japan have performed strongly, while Emerging Markets has lagged (albeit with a moderate underweight position)
- **Tactical Asset Allocation has added value –** throughout 2023 we added value both on the long and short side, using leveraged ETFs
- **Looking forward** - The market has turned optimistic on rate cuts in the first half of 2024, pricing in a soft landing, with equity and bond markets both enjoying a Christmas rally. We have a more cautious view, and believe being flexible and nimble in the first half of 2024 will be critical again to outperformance.

How did we see the year play out? Adrian Rowley, CIO, provides a macro prospective:

From a macro perspective, things played out pretty much as we expected. Towards the end of 2022, we were never in the hard landing camp and didn't expect we would have a nasty recession in 2023. We were happy to buy into the market dips in 2022. However, coming into 2023, we were far more cautiously positioned. Our view was that tighter financial conditions would start to bite, that we would start to see economic growth slow down over the course of the year and earnings would have to be ratcheted down accordingly. That largely played out in **Australia**. Third quarter growth for the year was 0.2% with our economy growing at about 1%. It has slowed down to a level we expected. As a result, analysts have had to rachet down their earnings forecast for the Australian market.

The **Chinese** economy has been relatively weak. 2023 was a little bit stronger than the previous year, but it's been much weaker than the PBOC's (People's Bank of China) target. Whilst they have been slowly stimulating, it has been very tentative at this stage.

Europe is probably in recession now. Albeit a very mild recession. Again, a lot of that has played out as we expected.

What really has surprised us, has been the strength of the **US** economy, the strength of the US consumer, and consequently the strength of the US market.

After a tough year for the US market in 2022, the US S&P500 was up approximately 25% for 2023. The Watershed International Share Portfolio finished the year up almost 30% and has done really well. That did surprise us. The Portfolio has been sitting on 19% cash for most of 2023. But despite the higher cash holding, it has had a great year of performance.

What other surprises did 2023 offer?

What also surprised us was that the strong correlation between bond and equity markets didn't break. For a long period of time, we have had periods where bond markets rally, everyone is expecting rate cuts or a peak in the cycle, and equity markets rally.

Again, in mid-December we saw the Fed pause. Their commentary was a bit more dovish. We saw a huge rally in bond markets and a huge rally in equity markets. That has surprised us to a degree, but looking longer term we don't think we are wrong there (that the correlation will break), it has just been delayed. It was the biggest driver again of markets in 2023 and it probably will be in 2024 but maybe in a completely different way.

What did Fred Strauss, Watershed International Portfolio Manager, have to say about the performance for the International Share Portfolio?

Technology stocks were again a key driver. In 2022 we had a selloff in technology, driven by higher bond yields and market scepticism about whether the major technology stocks could maintain earnings growth. The change in 2023 was AI (Artificial Intelligence).

Microsoft came out with ChatGPT which consequently provided some comfort to the market on how they could monetise AI via their Office365 subscription service. Microsoft are now charging approximately double their current standard rate to access the AI version. As a result, the market got much more comfortable about earnings growth for the technology sector.

So even though we have seen a rally in bond yields earlier in 2023, up to 5% where it peaked, (it's now come back a bit), that didn't impact the technology stocks the way it did in 2022. To sum up, we have had really good performance from Microsoft, **Apple**, and even **Alphabet (Google**) despite the antitrust cases raised recently.

Delving deeper into the portfolio, Fred pointed out that whilst healthcare underperformed, the portfolio had an underweight position holding only **Johnson & Johnson**.

Fred believes **Amazon** deserves a special mention. In 2022 it underperformed quite significantly. They had to invest heavily in infrastructure for COVID and all the online shopping. But this year, they have turned it around and they are now getting efficiency out of that huge investment in infrastructure. Amazon recently reported very solid earnings especially on the American side of the business.

<u>What's the outlook from Ben Bowen, Emerging Leaders Portfolio Manager?</u>

The small-midcap space was really tough in 2023 for the second year in a row. Not just domestically, but globally. Mid-caps underperformed. We have spoken about this a bit in the past when institutional investors are anticipating a slowdown, the first thing they do to de-risk their portfolio, is to sell small-midcap stocks. But it now looks as though there is more interest in the sector.

From a performance perspective <u>the Emerging Leaders portfolio was up 7.5% for 2023 with the index only up just over 1%.</u> That's strong outperformance in a difficult environment. And that is a 7.5% positive return <u>where we carried almost 30% cash in the portfolio for most of the year.</u>

What's played out over the last 2 years is incredibly rare, in that you saw the small caps segment underperform the ASX200 by almost 20%. This is not surprising given the slowing economy and the rising rate environment, however this is not the norm over the long term.

What Ben has found interesting over the last 3 to 6 months is that investors are starting to expect small caps to recover and for a reversion to the mean.

Small caps comparatively are a lot cheaper at the moment. Purely from a quant perspective, it would seem to be a really good time to invest. However, <u>we have been a little bit more circumspect</u>. We think that a lot of what has been advocated to get on the front foot and get into small caps, for us, could be a little bit premature. If you look at earnings growth forecasts for the next 3 years, <u>the market is expecting EPS (earnings per share) growth of ~17% in small caps vs 2% in large caps. We are not sure that small caps forecast is going to hold up.</u> We think we are heading into an environment that will be a bit more tougher than we think.

In this environment it's really hard to pick the right entry points. We have never seen a reporting season like the last reporting season where your average movement in small cap stocks was either positive 10% or negative 10%. This demonstrates there is a lot of money looking at the sector, though tentatively. So, when we have positive market months small caps have massively outperform large caps. But conversely, there is still a lot of nervousness out there and when we have a negative market month, they tend to get hit a lot harder.

It's also reflective in the sector movements. In November, a positive month, we saw the tech stocks up 12-13%. <u>It's pretty clear that investors are positioning themselves for the recovery. The tension here is whether or not this is premature and when is the best time to get fully invested.</u>

With that macro view, we think there is synchronicity right across all the portfolios (e.g. - Australian Share, Emerging Leaders, International Share) that we still genuinely feel the worst of the economic downturn is probably still ahead of us in 2024. The million-dollar question is whether markets will look through that and start to price in recovery and a cut in rates or whether there will be a negative reaction to downgrades in the first half of the year.

<u>Hamish Kelso, Portfolio Manager, provides insight on how things played out for the Income Portfolio:</u>

The fixed income space has been interesting this year coming off one of the biggest sell offs in recent bond history. We have been bullish on the sector this year as the world adjusts from a record low rate environment. Central banks have found it hard to navigate the inflation numbers that have been more persistent than everyone expected. They are trying to manage their movement in monetary policy to navigate a soft landing.

<u>We came into the start of the bond market sell off with zero market duration and progressively increased this over the year to just under 30% mainly through adding **Australian Government Bonds** and **US Treasuries**</u>.

This has been largely funded from reducing high yield credit and floating rate exposure which has comprised the bulk of the portfolio for the last decade as interest rates have been progressively moving down.

The Income Portfolio is up 5.5% calendar year to date (December 2023) compared to traditional bond indexes which are down ~1.8%. This was significant outperformance especially over the last couple of years where bond indexes have been hit.

We have gone from zero developed market duration from the start of 2022 to almost 30% now. We are not in the hard landing camp. If we were, that weight would be 60% or 70%. We've still got a good core allocation to high yield, emerging market debt and floating rate notes. But as we move further through the rate cycle or if our macro view changes, we will shift those allocations accordingly.

How does Graeme Miller, Portfolio Manager, see performance across the International ETF allocation?

Overall, the International ETF portfolio is up ~13% for the year. A big driver of that going into 2023 is that we have been entirely unhedged which has worked well in an environment where the US dollar has outperformed the Australian dollar. We've seen a bit of a flight to quality and also the Euro has outperformed the Australian dollar as well. Fears around escalation in the Ukraine has subsided, which has helped the Euro bounce strongly.

If we look on a regional basis our exposure to Europe is up around 20%. Japan has also performed really well and is up around 18%. What has lagged has been our exposure to Emerging Markets, up only ~5% for the year although we continue to be moderately underweight. Looking forward Emerging Markets might be the area we find more value coming into 2024.

Currently we use leveraged ETFs in the portfolio. How is this currently positioned and how has it performed?

Through the year we have at different periods used leveraged long and leveraged short US equity ETFs. The pleasing thing is, through the year we have been able to add value both on the long and the short side - **BBUS**, (US Equities Strong Bear ETF), has added just under 10%; and **GGUS** (Geared US Equities ETF) has added just under 14%. At present, we currently have a small US short back in the portfolio and that is a 2% position.

We use these ETFs as a way to adjust market exposure in a really flexible and dynamic way rather than trading underlying securities in the portfolios too frequently. We like to use these ETFs to adjust our exposure much more efficiently.

We have also done this in the large cap Australian Equity sleeve and, pleasingly, sold the rally at the start of 2023 when our market hit 7700 or thereabouts. It did grind lower over the course of the year but in a very volatile fashion. So, we've had long and short exposure from time to time and we've made money on both of those positions. We recently added the geared ETF after the August, September, October sell-off. Markets have now rebounded again. We sold that position a little bit early, but we are comfortable with that from a risk management perspective.

What do we think is going to happen next year?

The biggest question for markets is whether we have a soft landing or not. Clearly the consensus view is there will be a soft landing, with the market also pricing in ~ 100bps of rate cuts from the Fed. What is interesting is that it was all priced for the second half of the year only a month or so ago and that has shifted to the first half. The market has turned pretty bullish on rate cuts in the first half of 2024, pricing in a soft landing, with equity and bond markets both rallying.

However, due to the lag in monetary policy we are still yet to see the full impact of higher rates on the real economy. That is still to play out in 2024 especially on the consumer spending side, which we are starting to see in Australia. On the positive side, central banks will have ample room to cut rates. Even if in the soft landing scenario, if you have weak GDP growth (positive, but weak), and if inflation is under control, then the Fed may say there is no need for a 5.25% target rate and could start cutting rates.

We have a more cautious view in that we have never had a period where interest rates have increased this much without a recession and to think that it will be different this time is always a really dangerous comment to make in financial markets. Therefore, our view is that the worst of the economic and earnings downturn is still ahead of us and that will happen either in the first half of 2024 or towards the middle of the year. The key question is, will markets react to that, or will they look through it and continue to price in the economic recovery? With markets enjoying a strong end-of-year rally, we have trimmed equity exposure and have been building up cash again.

In summary, we are really pleased to have delivered great performance in 2023, with all sleeves in the multi-asset portfolios performing well despite relatively conservative positioning over the course of the year. We believe being flexible and nimble in the first half of 2024 will be critical again to outperformance.

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