Betashares 2024 Outlook and Portfolio Implementation

What, when and how.

Can central bankers thread the policy rate needle? And investing for any outcome.

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Key takeaways

- Inflation is slowing and the bulk of interest rate hikes appear to be behind us.
- A 'soft landing' – where conditions are tight enough to slow inflation, but not so tight as to cause a recession – appears increasingly likely.
- The key risks are stubborn inflation, rising unemployment, and geopolitical tensions across Europe, the Middle East, and Asia.
- Tactically investors can use ETFs to position themselves depending on their expected economic outcome. We offer suitable ETFs for the four alternate scenarios.
- Strategically investors can use 'all weather' funds to enhance the core of a well-diversified portfolio. We offer four solutions across major asset classes.

Economic and market outlook 2024

David Bassanese, Chief Economist

The global economy's V-shaped recovery from the COVID crisis was a much better economic outcome than many dared to dream in the dark early months of 2020.

Yet the joy of a strong economic recovery over 2021 was quickly replaced by fear of the high inflation that it caused. By mid-2022 concern had shifted back to the fear of recession, as central banks aggressively raised interest rates to contain the worst inflation outbreak since the 1970's.

History suggested a return to low inflation would not be possible without a sharp rise in unemployment and a likely global recession.

Yet heading into 2024, investors are once again daring to dream of a much better economic outcome than first feared. Although global and Australian economic growth has slowed, it has demonstrated surprising resilience in the face of interest rate hikes to date. At the same time, the absence of recession has not prevented inflation in most parts of the developed world from falling almost as quickly as it rose.

The case for an economic soft landing

The combination of surprising economic resilience yet falling inflation has increased the chances of a soft landing. Despite similar inflation levels to that of the 1970s, it's looking like history need not repeat – recession could be averted.

How so?

For starters, the nature of the inflation shocks differ. Whereas the high inflation of the 1970s was initially caused by two successive negative supply shocks – OPEC production cuts which led to a surge in energy costs – the post-COVID inflation largely reflects a positive demand shock. The 1970s shocks pushed up inflation while also pushing down economic growth, making recession harder to avoid. By contrast, the recent burst of inflation has largely reflected a strong post-COVID demand recovery running ahead of available goods and labour supply.

As demand has moderated and supply belatedly caught up, pricing pressures have eased – first in the goods sector and increasingly in the services sector. What's more, thanks to better anchored inflation expectations and arguably stronger competitive pressures – due to widespread technology disruption and globalised markets – the initial burst of inflation has not become embedded through a wage-price spiral.

What does this mean for Australia?

My expectation is that the disinflation trends we are seeing in the global goods sector will increasingly filter through to Australia, while service sector price increases will also slow as cost pressures ease. Lower inflation will, in turn, help boost real household incomes, which along with RBA rate cuts will support a second half rebound in consumer spending.

I expect the economy will grow by 2.25% over the year to end-2024, though the unemployment rate will still edge higher to 4.25%. The best news is that I expect annual trimmed mean underlying inflation to end the year at 2.75%, well below the RBA's current expectation of 3.25%.

A lower-than-expected inflation path and increase in unemployment will allow the RBA to cut interest rates in 2024, with my base case being cuts at the August and November policy meetings. Falling inflation and rate cuts by both the RBA and US Federal Reserve should support further declines in bond yields, bolstering fixed income returns.

Despite RBA rate cuts, the **Australian dollar** should also strengthen, reflecting earlier and more aggressive US interest rate cuts and an improving global economy, which is expected to reduce the "safe haven" demand for the US dollar. I expect the AUD to end the year at US75c.

A soft landing for the global economy bodes well for the equity market outlook, including that in Australia. With lower bond yields supporting equity valuations and a gradual recovery in corporate earnings, I expect the S&P/ASX 200 to reach 8,000 by year-end.

All up, the base case 'soft landing' scenario bodes well for both bond and equity markets in 2024. Within equity markets, moreover, such a scenario could also tend to favour cyclical and growth exposures, such as consumer discretionary and technology stocks – though high valuations in the latter sector especially could hold back relative performance.

Economic and market outlook 2024

Economic risks and assessed scenario likelihoods

While I assign a probability of a soft landing of 60%, risks remain. As outlined in the chart below, alternate scenarios are still possible.

One risk scenario is economic overheating (20% assigned probability) through sticky wages and service sector inflation, given that labour markets generally remain tight. This would have mixed implications for equity markets, though tend to favour value exposures such as financials and energy. It would be bad for fixed-rate bonds as central banks were forced to raise rates further. Again, this scenario should be averted provided overall economic growth keeps easing and labour supply continues to recover.

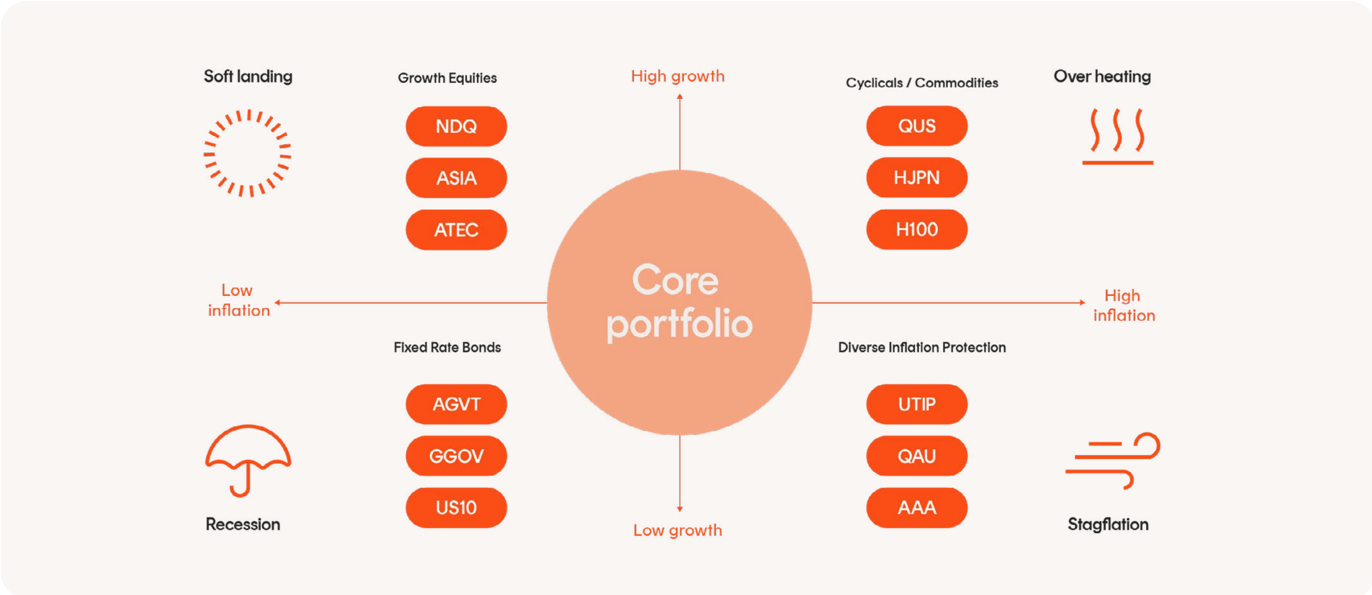
Of course, a recession is still possible, with an assigned probability of 15% – as the lagged impact of past interest rate increases continue to flow through the economy.

This would be bad for stocks, but especially favour fixed-rate bonds if central banks moved to aggressively cut interest rates. Countering this risk, households still appear to have substantial savings buffers. Corporate balance sheets also remain healthy and business investment solid.

A final risk is geopolitical – an escalation in the tragic conflicts in the Middle East and Europe that (more akin to the 1970s) creates a "stagflationary" lift in both inflation and unemployment due to a surge in global food or energy prices. As in early 2022, cash and commodity-type exposures might be most favoured under this scenario.

So far at least, geopolitical tensions remain contained, and the consequences of an escalation could be so disruptive that major players such as the US, Europe and the Middle East will likely continue to try hard to avoid it.

Tactical investments for each economic outcome



Soft landing

This is the desirable outcome for investors, and could be favourable for both bond and equity markets. Growth equities may be best placed, including 2023's AI winners if they can deliver on strong expected earnings growth, and previously out-of-favour emerging markets and small cap growth:

ASX : NDQ	Betashares Nasdaq 100 ETF
ASX : ASIA	Betashares Asia Technology Tigers ETF
ASX : ATEC	Betashares S&P/ASX Australian Technology ETF

Overheating

In an overheating scenario, companies with pricing power may benefit from resilient consumer spending and increasing demand – in which case cyclically-tilted broad market exposures or commodity-related sectors may be well placed:

ASX : QUS	Betashares S&P 500 Equal Weight ETF
ASX : H100	Betashares FTSE 100 Currency Hedged ETF
ASX: HJPN	Japan ETF– Currency Hedged

Recession

In a recession, the typical playbook has called for defensive positioning in a risk-off environment – with high-quality bonds acting as a valuable portfolio diversifier to equities:

ASX : GGOV	Betashares U.S. Treasury Bond 20+ Year ETF – Currency Hedged
ASX : US10	Betashares U.S. Treasury Bond 7-10 Year – Currency Hedged ETF
ASX : AGVT	Betashares Australian Government Bond ETF

Stagflation

It may be difficult to generate positive real returns in this scenario. One option is inflation-linked bonds, which are likely to appreciate on falling real rates. Gold (lower real rates reduce the opportunity cost of gold ownership) and commodities with inelastic demand may also do comparatively well.

ASX : UTIP	Betashares Inflation-Protected U.S. Treasury Bond – Currency Hedged ETF
ASX : QAU	Betashares Gold Bullion ETF – Currency Hedged
ASX : AAA	Betashares Australian High Interest Cash ETF

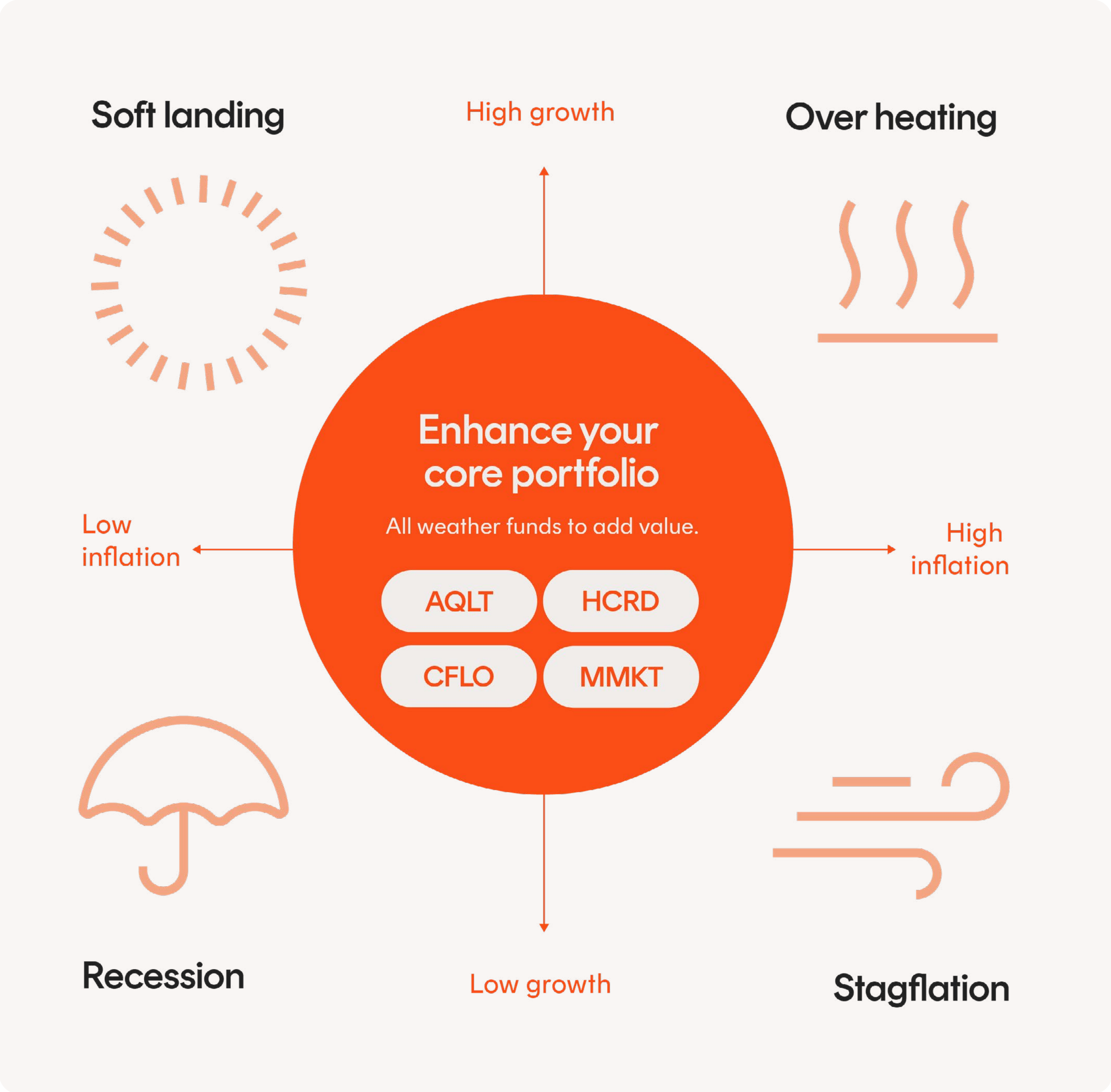
'All weather' funds for various economic outcomes

No matter what scenario plays out in 2024, investors should use funds at the core of their portfolios suitable for various economic outcomes!

'All weather' ETFs can act as the bedrock of a well-diversified portfolio complemented by the tactical funds above for a given economic environment.

Many advisers seek to include broad equity market beta at the lowest possible cost as part of an 'all weather' core. But beyond low-cost beta, how can you add value?

These four funds solve for commonly cited challenges faced by Australian investors. These funds are intended to be held throughout the market cycle in the core of your portfolio – 'all weather' solutions that can be held over the long term to reduce turnover and transaction costs.



Source: Sharpe, W. F. (1991). The Arithmetic of Active Management. Financial Analysts Journal, 47(1), 7–9. http://www.jstor.org/stable/4479386

International equities

Seeking alpha without significant deviation

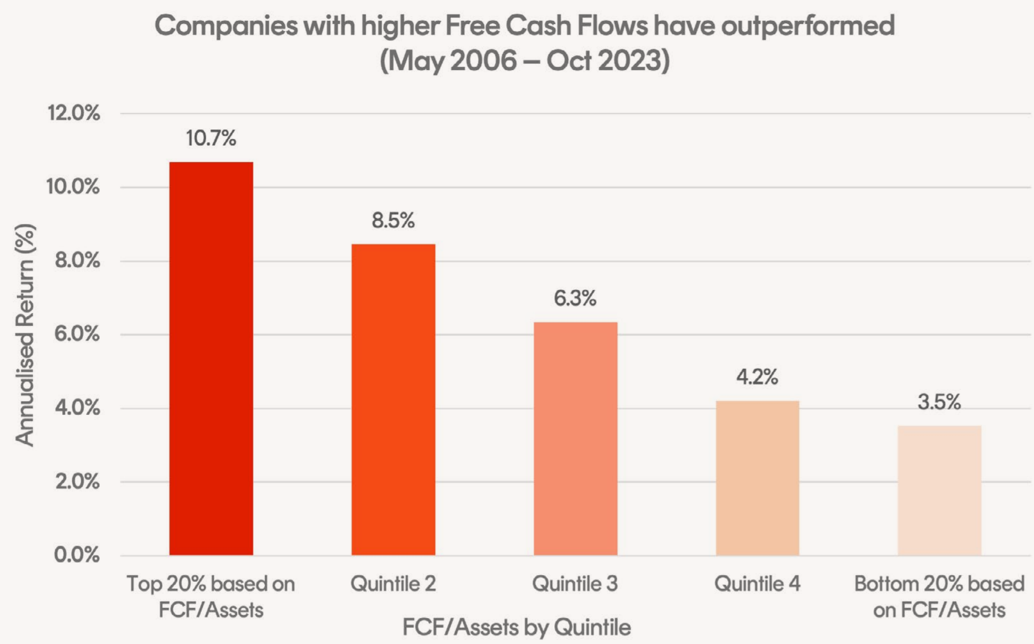
There are significant advantages to including some low-cost equity beta in client portfolios. But how do you add value beyond tracking the broad index? The most common answer is to also include actively managed funds with the potential to deliver outperformance relative to funds that track traditional benchmarks alone.

However, generating alpha is a competitive (arguably zero-sum[1]), high-cost game, and the growth of indexing has exposed closet "index huggers" and created a shift towards high conviction and index unaware active strategies. While such strategies have the potential to deliver alpha, they also tend to suffer from periods of significant underperformance.

Betashares Global Cash Flow Kings ETF (ASX: CFLO) tracks an enhanced index comprising a globally diversified portfolio of companies that demonstrate strong free cash flow with relatively low levels of financial leverage.

Over the cycle, such companies are better placed to:

- Invest in profitable growth opportunities when the economy is strong;
- Service or pay down debt, with less reliance on funding markets or dilutive capital raising in periods of stress; and
- Outperform broad global equity benchmarks over the medium to long term.



Source: Betashares, Solactive and FactSet. Chart shows five equally weighted portfolios representing the Solactive GBS Developed Markets ex Australia Large & Mid Cap AUD Index constituents broken up into quintiles based on FCF generation, and rebalanced semi-annually. Data covers the period from May 2006 to October 2023. Financial companies are ranked by Net Operating Cash Flow / Assets, instead of FCF / Assets. You cannot invest directly in an index. Past performance is not an indicator of future performance.

CFLO's index uniquely neutralises sector differences to the broad market benchmark, and controls for country differences. In doing so, it seeks to reduce the risk of periods of significant underperformance.

CFLO offers the best of both worlds - outperformance potential relative to a fund that tracks a traditional benchmark alone, with the cost effectiveness typically expected of ETFs.

And because CFLO has a far lower cost drag than the average active manager, its strategy can support a more 'index aware' approach that reduces the risk of underperformance associated with more high conviction active strategies.

To find out more about CFLO - click here

Australian equities

Finding balance in Australia's top-heavy market

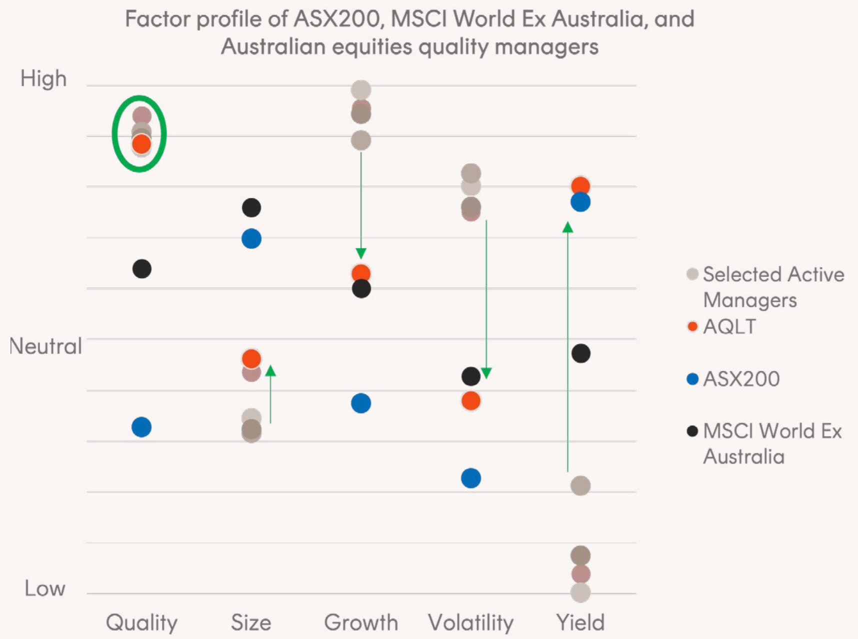
Australian investors are faced with a domestic market concentrated in large mature companies from cyclical industries.

While this makeup typically caters to our high dividend yield preferences, it has historically come at the expense of profitability, growth and price appreciation (not to be mistaken with total returns, which includes dividend income). From 2014 to 2023 the companies underlying the S&P/ASX 200 grew earnings on average 4%p.a. while the index's price returned 42%, by comparison over the same period, the US' S&P 500 experienced 7%p.a. earnings growth and 237% price growth – significantly higher than our market.

Considering this and examining the profile of the broad Australian market, (represented by the benchmark S&P/ASX 200 Index – the blue dot below) we can hypothesise an enhanced solution to broad market investing in Australia – i.e. upweighting to higher quality companies.

Quality companies are defined by their high return on invested equity, low levels of leverage and earning stability. Historically, companies with these attributes have outperformed broader benchmarks while displaying defensive properties. Taking a quality investment approach in Australia could therefore improve profitability and solve for our market's relatively low returns.

In fact, several active Australian fund managers already take this approach. Represented by the brown dots below these managers achieve their goal of a higher quality exposure to Australian equities. However, pursuing this sole aim can come at the arguably undesirable result of a very high growth and volatile portfolio – leading to periods of significant deviations from the benchmark.



Source: Morningstar. As at 31 December 2023. Selected Active Quality Peers selected from Australian domiciled Australian equity active funds with similar factor profile to Betashares Australian Quality ETF (ASX: AQLT) (as determined by Betashares). You cannot invest directly in an index. Past performance is not indicative of future performance of any index or fund.

Betashares Australian Quality ETF (ASX: AQLT), Australia's only passive quality Australian equities ETF, takes a more considered approach. AQLT maintains exposure to the largest Australian companies – weighting them by their quality attributes rather than size. It also holds and weights the highest quality companies from the remainder of the S&P/ASX200.

The result, as represented by the orange dot above, is a more balanced portfolio profile with an emphasis on quality. Resulting in AQLT's index historically outperforming the largest Australian active managers while not suffering from the significant deviations from the benchmark that Australian active quality fund managers have.

To find out more about AQLT - click here

Core cash allocation

Earning more in your core

Locking away money in a term deposit generates a premium for liquidity, but it does so at the cost of one of cash's greatest investment properties – optionality.

In the chart below, the black line represents the return from rolling 12-month term deposits with the red arrows representing the periods an investor could choose between this re-investment and investing in the S&P/ASX 200. The red line represents the returns from **Betashares Australian High Interest Cash ETF (ASX: AAA).**

Both investments ended the period with similar returns – with AAA outperforming 12-month term deposits over the period. Significantly, investors in AAA also had the option to re-invest in the market at any time over the 5-year period. Doing so at any period between the 2019 and 2020 term deposit rolls for instance could have improved an investor's total returns.

Nevertheless, in the pursuit of higher income many investors still turn to term deposits. What if there was a middle ground?

Money market securities are highly liquid, low risk, and short-term debt obligations between governments, financial institutions and large corporations. These securities are classified as cash equivalents by the investing community, but are typically only available to large wholesale and institutional investors due to high minimum investment hurdles and the level of investment expertise typically required.

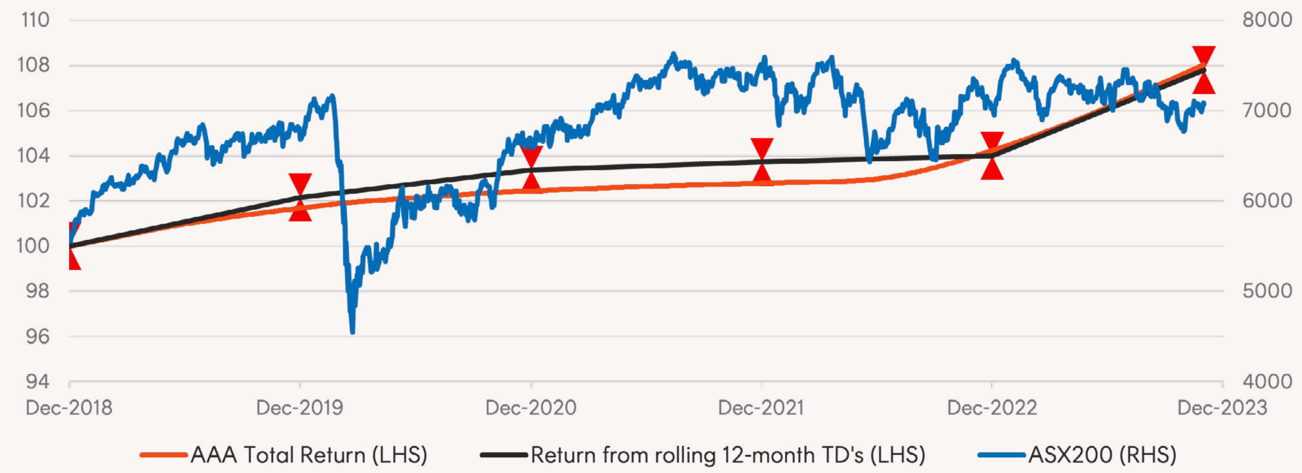
Betashares Australian Cash Plus Fund (managed fund) (ASX: MMKT) now offers investors with access to a portfolio of cash and Australian denominated money market securities.

MMKT currently offers a net-of-fee estimated yield-to-maturity of 4.67% p.a. (as at 22 January 2024*), making it potentially competitive against 12-month term deposits. Unlike term deposits, which are simple interest accounts, MMKT's interest compounds, making the fund's equivalent 12 month estimated net-of-fee return 4.71%*.

Importantly, MMKT, which among money market securities, can also hold term deposits in its underlying portfolio, is traded on the ASX and provides T+2 liquidity. For investors looking to enhance the yield on their cash allocation without foregoing its optionality, MMKT, could be an attractive solution.

To find out more about MMKT- click here

Performance comparison of ASX200, High Interest Cash ETF, and rolling 12-month term deposits
5 years to 31 December 2023



Source: RBA, Betashares. Figures for 'banks' term deposits', where available, are averages of the five largest banks' rates

*Yield will vary and may be lower at time of investment. Past performance is not an indicator of future performance.

Fixed income

How can you generate attractive income, with high levels of capital stability **and** liquidity?

Prior to the current rate hiking cycle, many investors found it challenging to meet their income needs from a traditional asset allocation.

The yields on offer in the public investment grade credit and bond markets were underwhelming. So some turned to private credit funds, seeking higher income and apparent capital stability, albeit in benign economic conditions. Private credit funds typically lend to borrowers that are unable to access bank financing or capital markets, with very little investor reporting of who these borrowers are or indeed the terms of the loans. While private credit funds in the US can provide exposure to quite a diverse range of borrowers, in Australia, private credit exposure is almost entirely real estate related[1]. The questions private credit investors should ask themselves are:

- Do you know what the counterparty risk is?
- How will these borrowers perform in a higher rate environment and/or a prolonged property downturn?
- Do you still need to take this counterparty risk to meet your income needs, now that you can earn significantly more from traditional fixed income securities?

Betashares Interest Rate Hedged Australian Investment Grade Corporate Bond ETF (ASX: HCRD) offers investors an alternative, with exposure to Australian investment grade corporate bonds issued by companies which are the lifeblood of the Australian economy.

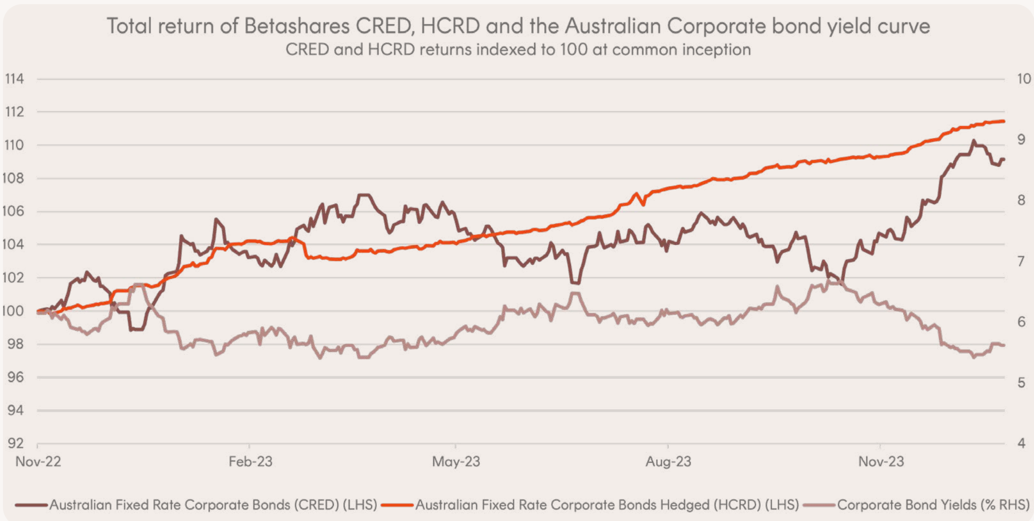
Bond issuers include infrastructure providers, such as Australian Pacific Airports, NBN Co, Transgrid, AusNet and WestConnex, and leading Australian and global corporates such as Coles, Woolworths, Wesfarmers, McDonalds and Verizon[2].

As opposed to private credit, HCRD provides investors with:

- Ready liquidity on a T+2 basis, in good times and bad,
- Daily transparency of the investment portfolio, and
- Greater certainty of valuations and entry and exit prices, with the underlying portfolio marked-to-market daily.

HCRD seeks to provide an attractive yield by harvesting credit premia while maintaining a relatively high degree of capital stability. HCRD does this by investing in our popular **Betashares Australian Investment Grade Corporate Bond ETF (ASX: CRED)** and hedging out the interest rate risk associated with CRED's fixed rate bond portfolio. The result is that HCRD provides a level of yield that might surprise you, with substantially reduced interest rate risk.

In fact, HCRD was the second best performing Australian Fixed Income ETF for the 2023 calendar year, returning 9.91%* (only bested by CRED, but with far lower volatility).



Source: Bloomberg. Australian Fixed Rate Corporate Bonds (CRED) represents Betashares Investment Grade Corporate Bond ETF (ASX: CRED) total return. Australian Fixed Rate Corporate Bonds Hedged (HCRD) represents Betashares Interest Rate Hedged Australian Investment Grade Corporate Bond ETF (ASX: HCRD). Corporate Bond Yields represents AUD Australian Corporate BBB 7y yield. As at 31 December 2023. Starting date chosen as inception of HCRD on 14 November 2022. Past performance is not an indicator of future performance.

In comparison, last year again saw discounts open up between the official NAVs and the ASX traded prices of ASX-listed private credit investment trusts. The collective wisdom of the market seems to imply the risk is greater than that reported in official performance figures.

HCRD now provides an alternative for investors seeking attractive income, a high degree of capital stability and daily liquidity, which in our view is well placed to weather all seasons.

To find out more about HCRD - click here

*Yield will vary and may be lower at time of investment. Past performance is not an indicator of future performance.

[1] AFR (https://www.afr.com/companies/financial-services/why-wall-street-s-alternative-asset-managers-are-singing-20231116-p5ekij)

[2] No assurance is given that bonds issued by these entities will remain in the funds portfolio or will be a profitable investment.

Funds covered in this report

Tactical positioning

Soft landing

ASX: NDQ	Betashares Nasdaq 100 ETF
ASX: ASIA	Betashares Asia Technology Tigers
ASX: ATEC	Betashares S&P/ASX Australian Technology ETF

Overheating

ASX: QUS	Betashares S&P 500 Equal Weight ETF
ASX: HJPN	Betashares Japan ETF – Currency Hedged
ASX: H100	Betashares FTSE 100 Currency Hedged ETF

Recession

ASX: AGVT	Betashares Australian Government Bond ETF
ASX: US10	Betashares U.S. Treasury Bond 7-10 Year Currency Hedged ETF
ASX: GGOV	Betashares U.S. Treasury Bond 20+ Year ETF – Currency Hedged

Stagflation

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ASX: QAU	Betashares Gold Bullion ETF – Currency Hedged
ASX: AAA	Betashares Australian High Interest Cash ETF

'All weather' funds

ASX: CFLO	Betashares Global Cash Flow Kings ETF
ASX: AQLT	Betashares Gold Bullion ETF – Betashares Australian Quality ETF
ASX: MMKT	Betashares Australian Cash Plus Fund (managed fund)
ASX: HCRD	Betashares Interest Rate Hedged Australian Investment Grade Corporate Bond ETF

Contributors

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Investment Strategist

Tom is responsible for undertaking investment research, analysis and providing market-leading research to clients.

About us

Betashares helps Australians build wealth.

As one of Australia's leading managers of ETFs, Betashares serves over 1 million investors and manages over $33 billion in assets across the broadest range of ETFs on the market.

Awards are only one factor to be taken into account when deciding whether to invest in a financial product. You should make your own assessment of the suitability of this information.

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Investing involves risk. Investment value and income distributions can go down as well as up. An investment in the Betashares Funds should only be made after considering your particular circumstances, including your tolerance for risk. An investment in MMKT does not receive the benefit of any government guarantee. For more information on the risks and other features of each of the Betashares Funds, please see the relevant Product Disclosure Statement and Target Market Determination, available at www.betashares.com.au.