

The Encyclical

September Quarter 2024

TO OUR PROFESSIONAL AND WHOLESALE INVESTORS

Market Review & Strategy

Major global share indices saw-toothed through the September quarter to close, more or less, at all-time highs. This followed on from the prior quarter where extraordinary foreign-based buying interest in the US stock market propelled shares skyward (BoA estimated ~US\$100bn in the month of June).

Investor sentiment shifted from indifference in the wake of reassuringly soft inflation in early July to being overwrought in response to slowing US payroll data in August and weaker construction activity updates in September.

The market sell-off from August 1 would prove cathartic for investors with bad news *actually* being bad news, a reckoning evidenced by an aggressive deleveraging across financial assets in several markets.

The Bank of Japan (BOJ) announced a surprise hike in interest rates which prompted a panicked unwind of the popular yen carry trade (borrow in yen and deploy into higher yielding foreign currencies). Positioning was reported at historic extremes and it is estimated that circa 60% of yen short positions were covered during the tumult. The Japanese stock market staged its biggest sell-off since 1987, losing ~16% in response to the BOJ's move.

Coincident with this in the US, the Bureau of Labour Statistics released softer than expected employment numbers and myriad economic commentators declared the actuation of the *Sahm Rule* (a recession confirmation signal based on rate of change in unemployment). US bond markets rallied and stocks retreated in reaction, forcing the covering of significant short correlation and volatility trades. Stocks had recovered by the second week of August and, notwithstanding an early September wobble, rallied into the Federal Reserves 0.50% rate cut announcement on 18 September—the first cut to rates since March 2020.

A quarter replete with surprises was to conclude with a series of announcements by numerous Chinese agencies detailing economic stimuli to defend the central government's 5% growth target. Initially aimed at stock market stabilization and then encompassing property policy and enhanced banking liquidity. Not unexpectedly, Chinese A/Hong Kong stocks rallied strongly. At home, resources stocks were well bid on the news, funded by a sell-off in over-extended banking shares.

Elsewhere, the local share market enjoyed an August reporting season that was ahead of, or at least, in line with analyst expectations. Despite an environment of rising input costs, industrial companies achieved impressive cost management and generally booked improved operating margins. Resource companies proved less adept in this regard with several also lifting capex intentions to the chagrin of investors. The major banks delivered impressive results/trading updates, rallying in response and ahead of profit taking into quarter end.

The pace (and value) of merger and acquisition activity slowed from previous quarters. US-based PE firm Lone Star bid for Orora, Mystate proposed a merger with Auswide Bank, Charter Hall Group and HostPlus revealed a joint tilt at Hotel Property Investments. Pilbara Minerals used a subdued lithium environment to bid for Latin Resources.

Elsewhere Woolworths quit their 4% Endeavour Group shareholding, BBRC sold its 14.7% interest in Accent Group and Apollo sold down a 10.6% stake in Challenger.

There was a modest equity call on the market during the quarter. Next DC raised \$750m, Fletcher Building raised \$700m, Auckland International Airport \$1.4B and Soul Pattis \$225m as a part of a broader refinancing package.

Technical Summary

Stocks

It is hard to find a chink in the technical picture for the US stock market, even the seasonal overlay (September traditionally the low point) and this year's 'presidential cycle' effect are chiming in with their positive predictive influences. Most of the major US stock indices monitored by us are conforming to the market's investment line (aka the 100-day moving average) indicating the market remains in uptrend. It is reassuring that investor sentiment is tracking to above average levels of bullishness but well shy of euphoria as measured by the US-based AII.

In recent *Encyclical's* I have warned of a pending change to the market order. In June I penned:

Market breadth and stock correlation measures are now plumbing new lows. This clustering will move to crescendo at some point when investors recognize that for the top 10, 'mega-tech' names, cycling sequentially higher quarterly earnings growth becomes increasingly difficult. The law of large numbers begins to impact.

New stock leaders will be sought out from sectors whose earnings begin to recover from depressed levels. Materials/energy, healthcare and industrial sectors might be where the hunting is best. The de-concentration (rotation) process once underway historically runs for multiple years.

This process might have just commenced with the extraordinary relief rally across Chinese stocks ushering in buying of global materials names, funded by the sale of outperforming banking/finance stocks across developed markets. Small Companies have outpaced big caps post the unveiling of Chinese stimuli.

The Encyclical has long been a proponent of long-term charts and their potency for investors. Take a look at how constructive the chart of the [Shanghai Stock Exchange 50 A-Share Index](#) is. A support line originating from 2005 has survived repeated tests along the way, including early in 2024 and again this month. The Williams % R oscillator clearly highlighting the oversold condition (highlighted below in green), enhancing the set-up for patient investors.

Shanghai Stock Exchange 50 A-Share Index



Source: Bloomberg

The Australian share market regained the ground quickly lost in early August to post recent historic highs. The ASX Small Ordinaries looks bullish and is now marginally outperforming the ASX20, a situation unthinkable heretofore. Small caps have work to do before they can reclaim the highs of early 2022.

Commodities/Currencies/Bonds

The US Dollar Index (DXY) looks vulnerable to lower price action as the unit sits at the bottom of the bullish trend channel configuring since mid 2011. Support at 100.00 is holding but will be thoroughly tested in coming weeks/months. CFTC futures positioning is surprisingly benign with the previous outsized long positions neatly trimmed in past months. The 'crosses' provide mixed signals for traders, ranging from a resilient British pound looking hard to suppress, an indecisive Euro, to a Yen that looks set to rally again. The Chinese Renminbi (Yuan) is poised to push higher versus the greenback with 7.30 reportedly a PBoC battleline. 6.82 appears the next logical target for the yuan.

The AUDUSD cross rate is at a crucial watershed and the outlook appears binary-stall or rally. Technical support from the covid lows has been rock solid and the perennial short futures positioning has been unwound to highlight a neutral stance from professional investors. The Aussie dollar will need to close convincingly above \$0.6905 to confirm the commencement of a major bull campaign.

Futures positioning in the Gold market is far less acute (Long:short positions 5.3:1 v 7.4:1 at the close of June quarter) but remains extended. New highs were almost a daily occurrence through the quarter but at the time of writing upside momentum appeared to be abating and US\$2685/oz safe from fresh challenge. Gold equities appear fatigued and in need of consolidation. A ten month long rising wedge suggests investor torpor might reasonably result in lower prices for gold stocks.

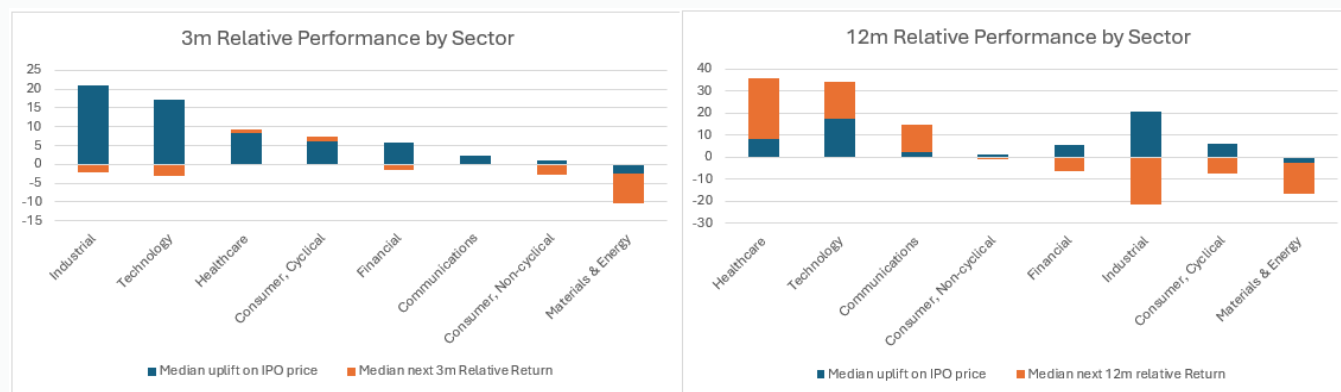
The price of silver has ground upwards in step with increased futures positioning. There are now 4.3 longs for every 1 short. The journey through to the historic high of US\$49.50/oz was always going to involve whipsaw's and not without misadventure. This is how the script is currently playing out.

The Bloomberg Energy Index (an amalgam of several oil and gas contracts) broke down during the early weeks of the quarter and price action since this time has been unconvincing.

The Log

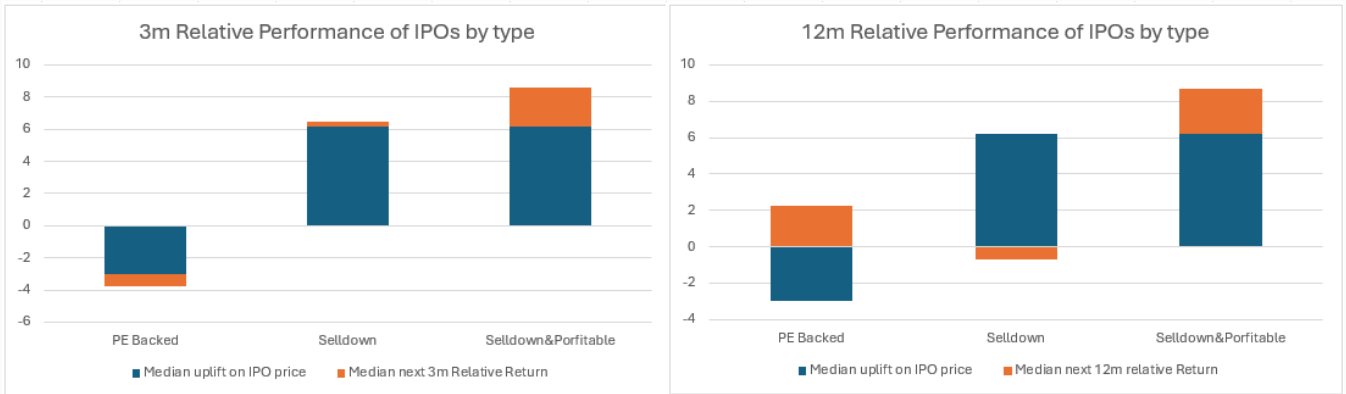
Eley Griffiths Group recently performed some analytics on the performance of initial public offerings. We ran the data on 500+ IPOs over the last decade. After eliminating LICs, ETFs and those companies below <\$100mil market cap, we ended up with a sample of just over 200. We found that even though the average IPO underperforms after 12 months, many IPOs are good short-term trades, and some go on to be 'multi-baggers'. In this abridged note we identify some key factors to help find winning IPOs.

Healthcare and Technology IPOs did best - Industrials also had a decent uplift on their IPO price upon listing. Materials and Energy did worst.



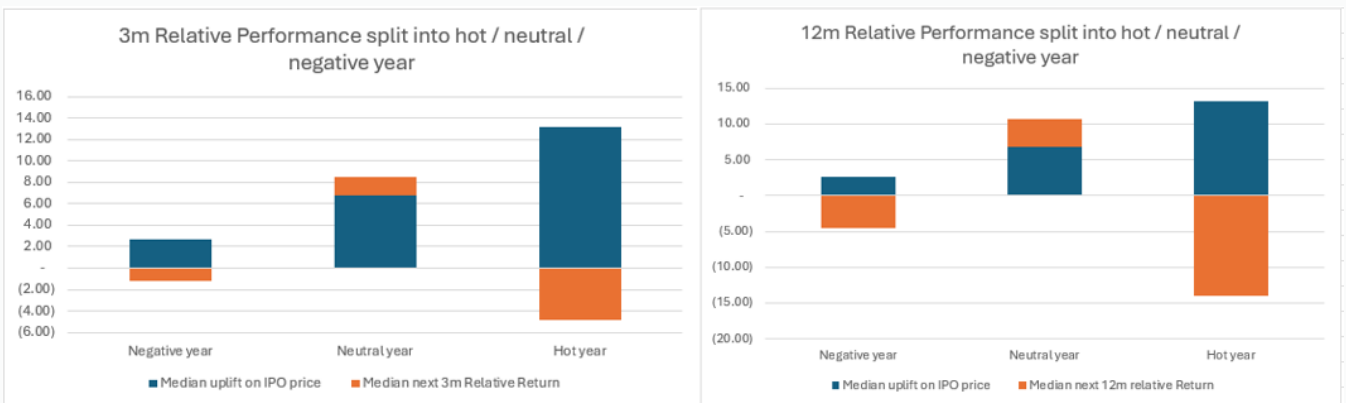
Source: Eley Griffiths Group, Bloomberg, FactSet

PE Backed beware but Selldowns not as bad as feared – The median private equity backed IPO did not rally on its debut and offered modest gains thereafter, whereas the median IPO with a vendor selldown did better, especially if it was EPS profitable.



Source: Eley Griffiths Group, Bloomberg, FactSet

Short term gain, longer term pain in a “hot” year - The data suggests a hot market certainly helps at the initial stage with prices surging above the IPO price on day one, but perhaps hinders in the subsequent months as the cycle turns.



Source: Eley Griffiths Group, Bloomberg, FactSet. ASX 300 used. Negative years: 2015, 2018 and 2022. Neutral: 2014, 2016, 2017, 2024. Hot: 2019, 2021, 2023.

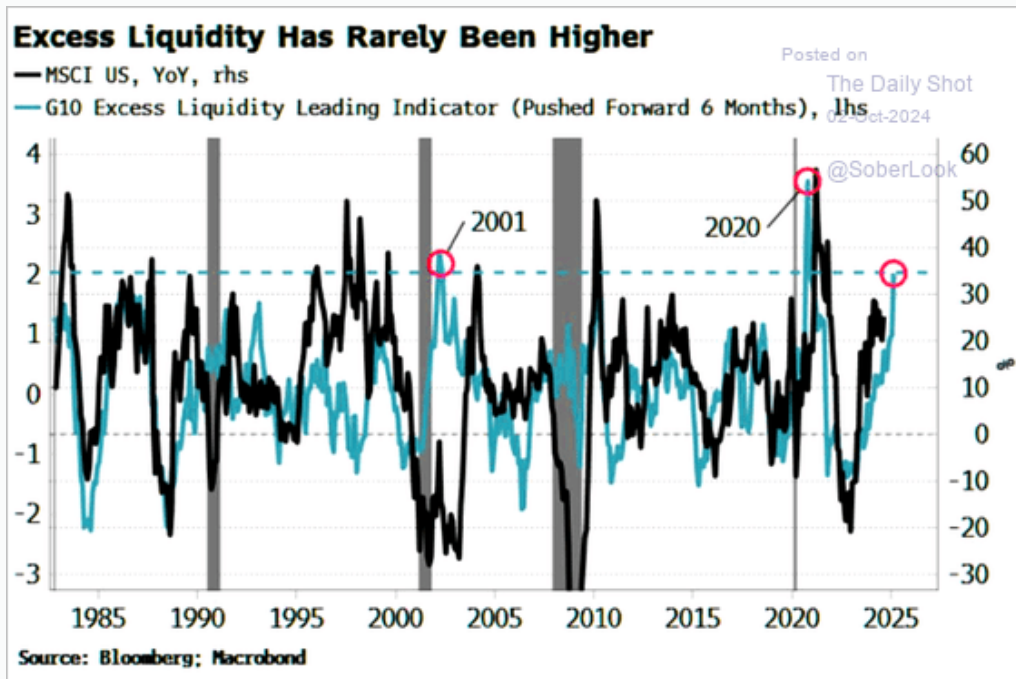
Outlook

The Encyclical enjoys rehashing the late German economist, Rudi Dornbusch's famous quote 'In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could'. This refrain couldn't be more apt to developments that unfolded in the dying days of the September quarter.

The FOMC cut interest rates by 0.50% then three days later the middle kingdom unveiled rapid-fire stimuli. These developments are unequivocally positive for risk assets, such as stocks, and are especially powerful when viewed in concert with increasing financial market liquidity and benign credit spreads. A somewhat reassuring state of affairs I would offer.

Liquidity is the lifeblood of markets and right now it is providing a significant underpinning to markets. A recent Bloomberg/Macroscopic commentary by Simon White reminded investors of the simple Marshallian K principle that market liquidity is the final product when economic growth (nominal GDP) is deducted from Monetary Supply growth (M1). White's chart below highlights the recent positive momentum in one measure of liquidity to levels last seen in 2020 and 2001.

Excess Liquidity Has Rarely Been Higher



Source: The Daily Shot

M1 typically contracts during rate hikes and rises during easing cycles with increased bank lending adding to the measure. Economic multipliers then do their thing in this environment of reducing rates and investors need to be alert to what this might mean for market dry-powder and its effect on short-medium term equity prices.

Ben Griffiths

Executive Chairman

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