Interest rates, the best it gets. It's time to deploy cash

Last year, a highly anticipated recession in Australia and the U.S. failed to materialise, surprising many investors and challenging the predictions of most forecasters. Looking ahead to 2024, a combination of increased yields and generally sensible valuations for growth-oriented companies suggests that forthcoming returns across various asset classes appear more promising than they have in quite some time.

By Roger Montgomery
Montgomery Investment Management
05 March 2024

Last year defied expectations. A widely anticipated recession here in Australia and the U.S. failed to materialise, proving many, if not most, forecasters wrong.

Our view was that the macroeconomic findings produced by Gavekal Research in 1978 – which have been demonstrably consistent since – would prove right again; a combination of disinflation (gradually declining rates of price increases) and some economic growth – even if anaemic – would set a positive backdrop for equities, especially those innovative companies with pricing power.

Witness the extraordinary march of the 'Magnificent Seven' mega cap technology stocks in 2023.

Table 1. 2023 calendar year performance of the 'Magnificent Seven' companies

Company	Ticker	Description	Change
S&P 500 Index			+24.20%
Nvidia	NVDA	Graphics processing and artificial intelligence	+238.90%
Meta Platforms	META	Owns social media including Facebook, WhatsApp and Instagram	+194.10%
Tesla	TSLA	Producer of electric vehicles	+101.70%
Amazon	AMZNW	E-commerce	+80.90%
Alphabet	GOOGL	Parent of Google	+58.30%
Microsoft	MSFT	Software company	+56.80%
Apple	AAPL	Consumer electronics and software	+48.20%

Source: Bloomberg (as at 31 December 2023, subject to change)

Each of these companies can be safely described as innovative and, perhaps with the exception of Tesla, have pricing power.

While many commentators will attribute their 2023 gains to the popularisation of the artificial intelligence (AI) thematic, it is curious that seven innovative companies with pricing power proved to be the best-performing group of stocks in an environment with an economic backdrop that included disinflation and positive economic growth, just as Gavekal predicted back in 1978.

But that was 2023.

What about 2024 and beyond?

A combination of higher yields and 'generally reasonable' equity valuations for growth companies means that future returns across several asset classes look more encouraging than they have for many years.

It's 'generally reasonable' because investors still have to pay up to 25 or even 30 times earnings for quality and proven growth. This, however, comes after a series of unprecedented interest rate rises. Those price to earnings (P/E) ratios, which reflect the popularity of stocks and the willingness of investors to buy a dollar of corporate earnings, could continue to rise if rates have indeed peaked, rendering current P/E ratios 'reasonable'.

I believe we haven't had so many attractive investment options since well before the pandemic. Equity returns in 2019 (pre-pandemic), for example, were good, but equities did seem expensive. Today, the growth prospects for many companies look as good, if not better, but valuations for some names seem relatively superior. By way of example, P/E ratios for U.S. small and mid-cap companies are materially lower in aggregate than they were in 2019, as shown in Figure 1.

Figure 1. Ed Yardeni P/E Chart S&P600 Small Cap Index with 2019 and 2024, highlighted

Source: LSEG Datastream and © Yardeni Research.
* Price divided by 52-week forward consensus expected operating earnings per share.

The economic backdrop this year will, we believe, be remarkably consistent with 2023.

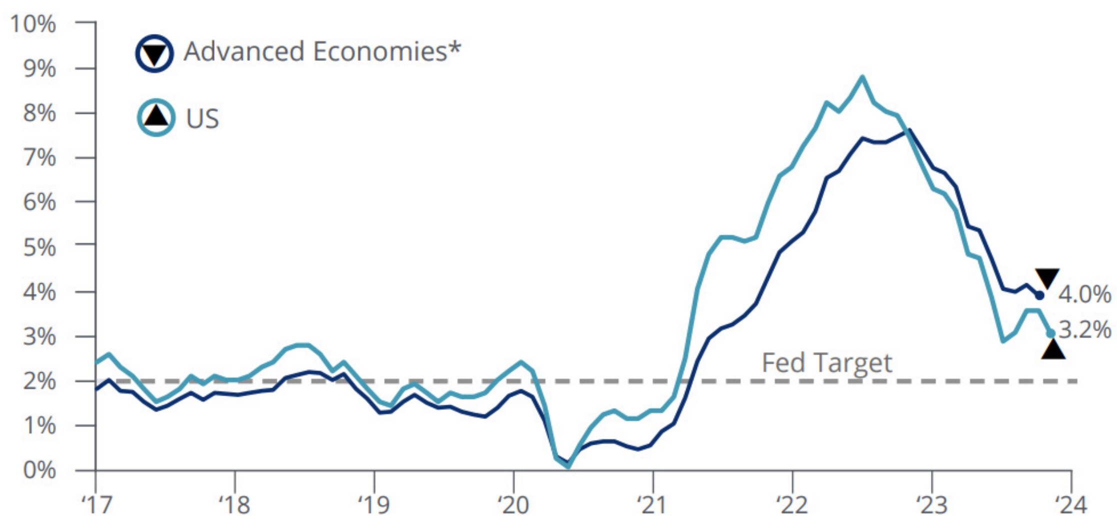
Disinflation should continue; interest rates, however, won't return to their pandemic lows. Corporate profits, especially for those innovative companies with pricing power, should continue to grow, and an absence of widespread layoffs should also keep major economies from entering a recession.

Finally, we think equity investors will start looking further down the market capitalisation spectrum for those innovative growth companies with pricing power whose shares haven't rallied as much as the 'Magnificent Seven'. Once investors have winnowed out the riskier or more doubtful companies and land on those, they are confident they have the ingredients for growth over two or three years, those smaller companies' shares could rally hard.

To add my two cents, I think equity markets will remain bullish until 2026.

Encouragingly, inflation is well past its peak and still heading in the right direction, as Figure 2. reveals.

Figure 2. Inflation retreats from historic highs –
Consumer Price Index (CPI), change year on year (YoY)



Our universe of advanced economies includes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, UK, U.S.

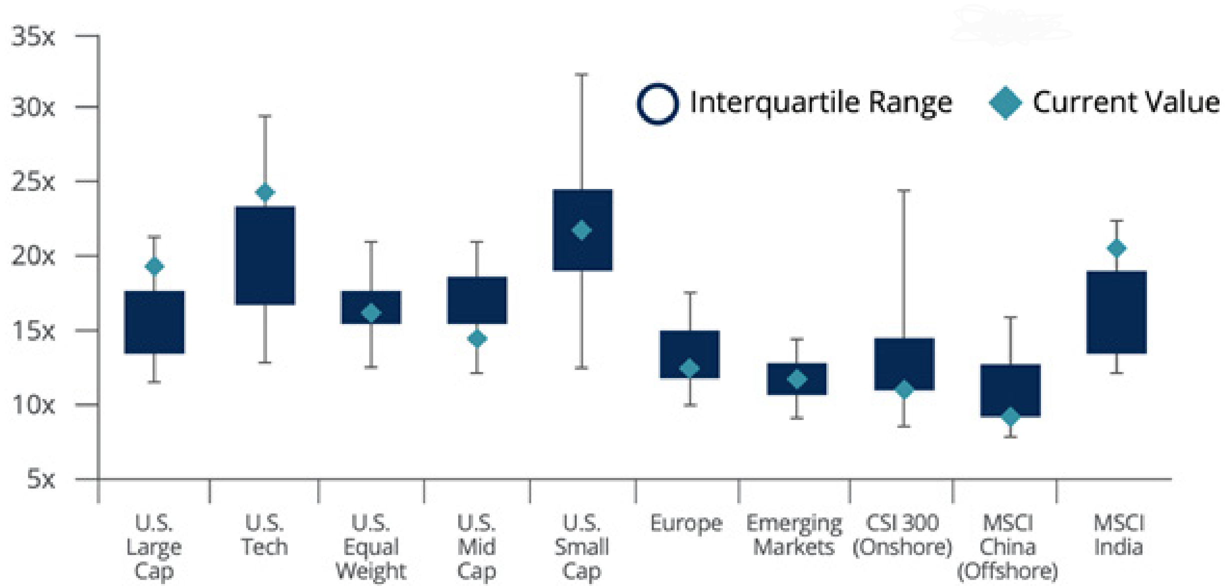
Sources: Bureau of Labor Statistics, Haver Analytics. Data as of October 31, 2023.

Source: J.P. Morgan

Of even more encouragement are the results of research conducted in late 2023 by J.P. Morgan, which found that the highest equity returns are generated when inflation ranges between two and three per cent. According to the investment bank's findings, the S&P 500 Index has generated average returns of 13.8 per cent per annum in years when inflation was below three per cent and above two per cent. When inflation was recorded below two per cent, S&P 500 annual returns averaged 10.7 per cent. And when inflation was above three per cent, returns averaged 8.5 per cent. Finally, when inflation was above five per cent, S&P 500 returns averaged just 2.4 per cent annually.

And remembering the investment axion, *'the lower the price you pay, the higher your return',* the value evident among domestic and global small and mid cap companies suggests returns could be boosted beyond the average thanks to relatively modest current valuations.

Figure 3. Valuation looks reasonable. 1 year forward P/E ratios relative to last 25 years



Source: Bloomberg, J.P. Morgan

With large caps 'Magnificent Seven' having roared in 2023, there is room for the historically consistent tendency for professional investors to commence scanning for opportunities further down the market capitalisation spectrum to be repeated. And that effort is likely to be spurred in part by the relatively more attractive valuations now on offer.

These lower valuations, of course, are a function of something. That 'something' is the anticipation of negative developments for corporate profits. Given that prices are, therefore, already factoring bad news, the downside must be limited if the bad news were to eventuate. Returns should be skewed to the upside then, with the prospect of positive surprises ever-present and costly for those who remain on the sidelines in cash.

Some forecasters believe aggregate corporate earnings should begin to improve. Given that our managers are, however, identifying individual companies demonstrating growing revenues and earnings, investors don't require 'aggregate' profits to grow. Having said that, we note, for example, the supportive argument that improving corporate earnings may emerge from the earnings recession over the last three quarters that most major S&P 500 sectors have experienced. And according to J.P. Morgan, earnings per share growth has occurred amid a quarter of the periods during which gross domestic product (GDP) went backwards. Remember, however, we aren't expecting a recession!

Equities are a source of long-term capital growth in portfolios, but of course, there are short periods where stocks can fall considerably, and there are long periods of recovery during which bonds have beaten returns from stocks.

For investors looking for diversification, however, bonds might not be the answer, given yields are falling, and inflation may persist at levels slightly higher than in the past. The latter could mean that the fixed yields offered by bonds may only marginally beat inflation, if at all.

Other opportunities?

One of the costs of higher interest rates is that companies suffer from higher debt financing costs. And because periods of rising interest rates are often accompanied by falling consumer demand, corporate profit margins can also be squeezed.

Some sectors may continue to struggle, if not suffer, in 2024. Commercial real estate, for example, and companies with relatively high levels of debt come to mind.

Figure 4. U.S. corporate net interest payments as a share of after-tax profits

Source: Haver Analytics. Data to 30 June 2023.
Recessions are shaded.

However, many small and medium-sized enterprises have little debt and are growing revenues and earnings at double-digit rates. Just as the Montgomery Small Companies Fund seeks to identify these Australian businesses to invest in their equity, and the Polen Capital Global Small and Mid Cap Fund seeks to do the same globally, the Aura High Yield SME Fund seeks small and medium-sized Australian corporates with the same quality characteristics to lend to.

In the U.S., by way of example, private or corporate credit has held up well across a number of global markets. In the U.S. and Europe, it has been observed that both investment grade and high yield corporates have taken advantage of low interest rates in recent years to "term out" (extend the maturities) their debts. Others have noted their cash balances are now yielding higher returns. The conclusion, reached by investment bank J.P. Morgan[1], for example, is that non-financial corporate interest payments as a share of after-tax profits are at their lowest levels since 1980.

The Aura Team managing the Aura High Yield SME Fund in Australia selectively lends to higher-quality small and medium-sized corporate borrowers. Riskier lending, such as currently for construction or development finance, is eschewed, differentiating the Aura High Yield SME Fund from other Private Credit Fund offerings. And thanks to a relatively limited flow of credit, attractive yields can be generated.

1 *https://privatebank.jpmorgan.com/nam/en/insights/latest-and-featured/outlook*

In addition to the more attractive yields potentially offered by private credit, diversification benefits may be superior to those offered by bonds, which are more highly correlated to equities when inflation is running at higher levels.

Private credit could provide useful opportunities to generate attractive income yields for investors with the capital or those for whom the volatility of equity markets doesn't appeal.

Conclusion

The coming year will undoubtedly contain risk. Those risks, however, will look different to those in the recent past. The prospect of a Trump election win could easily trigger nervousness by investors. However, these risks should not deter investors from making important investment decisions that will establish returns beyond the next election.

One view is that a valuation gap between small and large-cap companies could be sufficient to compensate investors who may have missed the 2023 rally in the mega-cap technology companies. Stick to higher quality companies demonstrating growth, those with structural tailwinds and tactical opportunities, for example, when markets treat a problem of a short-term nature as a permanent one. Alternatively, consider the Montgomery Small Companies Fund or the Polen Capital Global Small and Mid Cap Fund.

Investors who agree that the economic backdrop for equities is equally supportive for large-cap companies may also consider the Polen Capital Global Growth Fund for global exposure or the Montgomery [Private] Fund for exposure to high-quality Australian Companies.

Finally, the peak in interest rates will mean deriving attractive yields on cash, and cash-like investments become a priority again. Investors will want to avoid experiencing the income recessions they endured in recent years. Consider the Aura High Yield SME Fund, which seeks to generate attractive and reliable monthly income with target returns of 9-12 per cent per annum from a broadly diversified portfolio of loans to small and medium-sized businesses (SMEs) in Australia.

Learn more about our funds

If you would like to learn more about the Aura High Yield SME Fund (wholesale clients only), please visit the fund's web page to learn more: Aura High Yield SME Fund

If you would like to learn more about the Montgomery [Private] Fund (wholesale clients only), please visit the fund's web page to learn more: Montgomery [Private] Fund

If you would like to learn more about the Montgomery Small Companies Fund, please visit the fund's web page to learn more: Montgomery Small Companies Fund

If you would like to learn more about the Polen Capital Global Small and Mid Cap Fund, please visit the fund's web page to learn more: Polen Capital Global Small and Mid Cap Fund

Do you want to get in contact with the team at Montgomery?

Private Clients: Please call David Buckland or Toby Roberts on 02 8046 5000 or visit www.montinvest.com

Advisers/ Researchers/ Consultants: Please call Scott Phillips (NSW) on 02 8046 5005, Dean Curnow (NSW, ACT, WA) on 02 8046 5019, David Denby (VIC, TAS, SA) on 0455 086 484 or Michael Gallagher (QLD) on 0409 771 306.

Important Information

The issuer of units in The Montgomery [Private] Fund (Private Fund) is the Private Fund's trustee Fundhost Limited (ABN 69 092 517 087) (AFSL 233045). The Information Memorandum for the Private Fund contains all of the details of the offer.

The issuer of units in Montgomery Small Companies Fund (ARSN 635 229 533) (Fund) is the Fund's responsible entity Fundhost Limited (ABN 69 092 517 087) (AFSL 233045). The Fund's investment manager is Montgomery Lucent Investment Management Pty Limited (ABN 58 635 052 176, Authorised Representative No. 001277163).

The issuer of units in the Polen Capital Global Small and Mid Cap Fund (ARSN: 652 035 642) is the Fund's responsible entity Fundhost Limited (ABN 69 092 517 087) (AFSL: 233045). The issuer of units in the Polen Capital Global Growth Fund (ARSN: 647 518 723) is the Fund's responsible entity Fundhost Limited (ABN 69 092 517 087) (AFSL: 233045). The Product Disclosure Statement (PDS) contains all of the details of the offer. The issuer of units in the Polen Capital Global Emerging Markets Fund is the Fund's responsible entity Fundhost Limited (ABN 69 092 517 087) (AFSL: 233045). The Product Disclosure Statement (PDS) contains all of the details of the offer and is expected to be available in late 2022.

Units in the Aura High Yield SME Fund (Fund) are issued by Aura Funds Management Pty Ltd (ABN 96 607 158 814, Authorised Representative No. 1233893 of Aura Capital Pty Ltd (ABN 48 143 700 887, AFSL No. 366 230)) (Aura). Aura is the trustee of the Fund and a subsidiary of Aura Group Pty Ltd. This information is for wholesale or sophisticated investors only and is provided by Montgomery Investment Management Pty Ltd (ABN 73 139 161 701, AFSL No. 354 564) as the authorised distributor of the Fund. An investment in the Fund must be through a valid paper or online application form accompanying the Information Memorandum.

Copies of the PDS/ IM and Target Market Definition (TMD) are available from Montgomery Investment Management (02) 8046 5000 or at www.montinvest.com and at https://fundhost.com.au/ An investment in the Funds must be through a valid paper or online application form accompanying the PDS/ IM. Before making any decision to make or hold any investment in the Fund you should consider the PDS/IM and TMD in full. The information provided is general in nature and does not take into account your investment objectives, financial situation or particular needs. You should consider your own investment objectives, financial situation and particular needs before acting upon this information and consider seeking advice from a licensed financial advisor if necessary.