WATERSHED

FUNDS MANAGEMENT

LETTER FROM THE CIO

JULY 2024 END OF FINANCIAL YEAR REVIEW AND OUTLOOK

A LOOK AT THE YEAR THAT WAS, THOUGHTS ON THE YEAR AHEAD AND COMMENTARY AROUND CURRENT POSITIONING FROM WATERSHED FUNDS MANAGEMENT CIO, ADRIAN ROWLEY.

Watershed Funds Management

Watershed was established with a clear mission to partner with Independent Financial Advice firms, providing advisers with the support they need to grow and scale an efficient practice with a high quality, transparent, and differentiated investment service offering.

With a clear and value-adding investing philosophy and process, and stable investment team since inception, Watershed has established a strong track record of top quartile performance across our suite of multi-asset managed account portfolios since inception, across a range of market environments and multiple economic cycles.

ALL WE NEED IS JUST A LITTLE PATIENCE

We are currently retaining high cash weights and small short positions across the equity SMA's and Multi Asset portfolios, waiting patiently.

SUMMARY

We are waiting to see how the economic landscape evolves. Will we see only the second soft landing in recent (65 plus year) history, or is the world heading into recession?

Equity and Credit Markets have fully priced a soft landing. Even Bond markets are only pricing a mild reduction in rates.

The US economy is in our view clearly slowing, but at this stage still growing. Will US exceptionalism continue and will the AI Boom continue to structurally grow Big Tech earnings regardless of the economic cycle?

After increasing the cash rate 11 times for a total increase of 5.25% in 16 months, the Fed has been on hold now for 12 months. The world is waiting for the rate cutting cycle to begin but be careful what you wish for!

In Australia, economic growth is far weaker and inflation has recently trended back up. The RBA similarly raised the cash rate from 0.1% to 4% in thirteen months before pausing prematurely in June 2023 only to hike once more to 4.35% in November. The wait for rate cuts at home now looks to be even longer.

We are pleased to report however that despite very conservative (underweight) equity positioning in the second half of the financial year, five of our seven portfolio mandates beat benchmark and our multi asset portfolios remain at the top of the performance tables over 3 years, 5 years and since inception. Our High Growth portfolio was slightly below benchmark, but still delivered a 12% return for investors.

US ECONOMIC OUTLOOK

We start with the US as it remains the most important economy and market in the world. As the saying goes, if the US sneezes, the world catches a cold. This we believe is particularly relevant in Australia today as our largest trading partner in China, appears to be structurally challenged and may not be the driver of global growth over the next decade that it has been for almost twenty years now.

Last year, US growth surprised to the upside thanks to a continued fiscal impulse (huge government deficit spending) and a surge in labour supply from immigration. We have spoken many times about the expected long lag of monetary policy after the biggest global stimulus in history. And to us, it appears that tighter financial conditions are finally starting to bite, just as the world has celebrated an expected soft landing. Recent data prints have been soft, across both business and consumer. It looks as though excess Covid savings are now depleted and while retail sales grew 1.55% over the year, we note that this is well below the rate of inflation. Business equipment orders and shipments have softened, and both housing sales (new and existing) and housing starts are weak along with construction starts across all sectors (office, retail and industrial) remaining very soft.

The employment market is still strong, but we note that it is the most lagging of all indicators. We focus a lot on the employment market, as it is the spine of the economy and main driver of economic cycles. More on Employment later.

US MANUFACTURING AND SERVICES PMI'S

The chart below shows the ISM Manufacturing survey in blue and Services in red. A print below 50 indicates contraction, while a print above 50 indicates expansion.

One can clearly see below the sharp contraction in both manufacturing and services activity during the 2020 Covid lockdowns, followed by the sharp V shaped, stimulus driven recovery.

Figure 1 - US Manufacturing and Services PMIs

The huge pull forward purchase of durable goods during the Covid period saw a booming manufacturing sector. As the lockdowns ended, spending shifted to services and the manufacturing PMI dropped below 50 in October 2022 and remained there until briefly breaching 50 again in March this year. We have spoken often about the different, rolling cycles within the broader economy. Manufacturing tends to run in 3.5 year cycles absent larger economic shocks. A roughly 18 month period of expansion followed by an 18 month period of contraction - which intuitively makes sense given the replacement cycle of many durable goods. After declining steadily for just over two years from extremely elevated levels in 2021, the manufacturing sector looked like it was starting to bottom and recover over late 2023 and into 2024, just as services spending slowly started to normalise. However, the past 3 prints have again trended down and were all back below 50.

Services represent approximately 70% of US economic activity and monstrous stimulus from 2020 all the way into the start of 2023 saw services activity hit almost unprecedented levels as the world came out of lockdown. As mentioned earlier though, it appears that excess Covid savings are now largely exhausted and the services PMI is clearly trending down, with two of the last three prints below 50. As always, a few months does not make a trend, but both are now indicating contraction.

Looking at the Bloomberg Economic Surprise Index, most data is now surprising on the downside.

Figure 2 - Bloomberg Economic Surprise Index

US GDP growth has softened from over 5% at the recent peak, to 1.4% in the March quarter this year and consensus forecasts approximately 2% growth for calendar 2024. So, how much will the economy slow? Well, that depends on how the employment market holds up.

US EMPLOYMENT MARKET

Headline unemployment data looks solid, but under the surface we see signs of weakness. The jobs to workers gap is narrowing. That is, job openings are declining (despite the improvement last month) while the number of unemployed people looking for work is edging higher. This has not had a meaningful effect on the unemployment rate yet, as we have come from a point of extremely elevated job openings. That era is now ending.

In June the payrolls data showed 206,000 jobs created which is still a healthy number, but the Department of Labour also downgraded April and May numbers by 111,000.

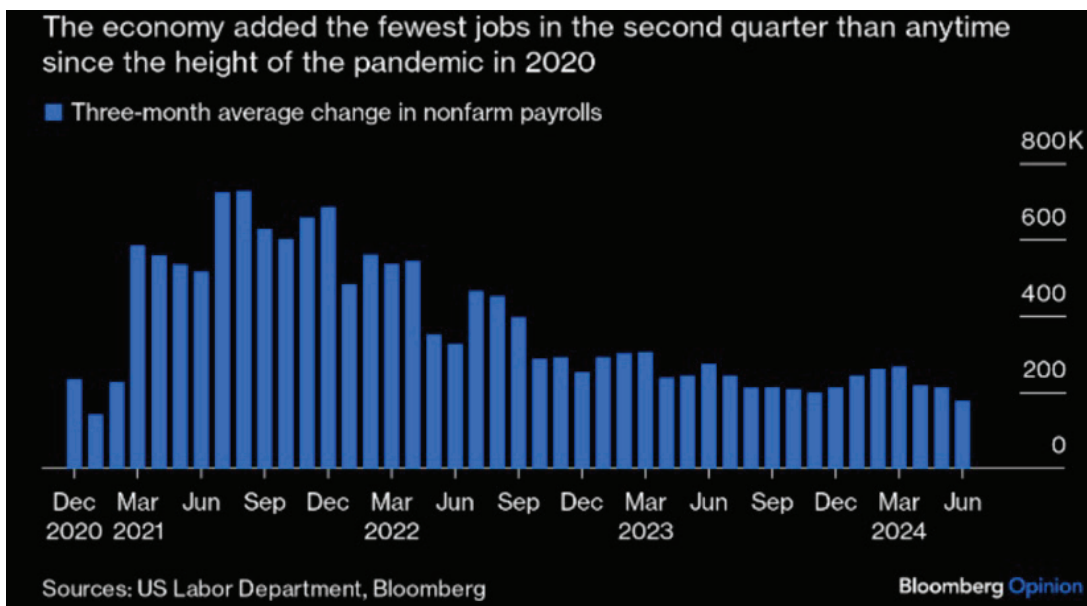

Figure 3 - **US Nonfarm Payrolls (3-month average change)**

Digging a little deeper, the time it takes for an unemployed person to find a new job is lengthening and the number of temporary employees on payrolls has dropped sharply. When the labour market cools, we first see a decline in new jobs advertised (tick), a decline in the quits rate (tick), reduction of hours worked (tick) followed by a reduction in temporary staff (tick). Laying off full time workers is the last resort for companies and usually only happens after profits fall and is therefore one of the most lagging indicators of the economic cycle and usually only starts rising in a meaningful way once a recession has started.

In June the unemployment rate edged up from 4% to 4.1%, which is still a very healthy level. But, to borrow a chart from BCA Research, the unemployment rate is very mean reverting and does not sit at either a high or low level for long and once it starts rising, it almost always continues to do so. Betting on a soft landing, is betting against history.

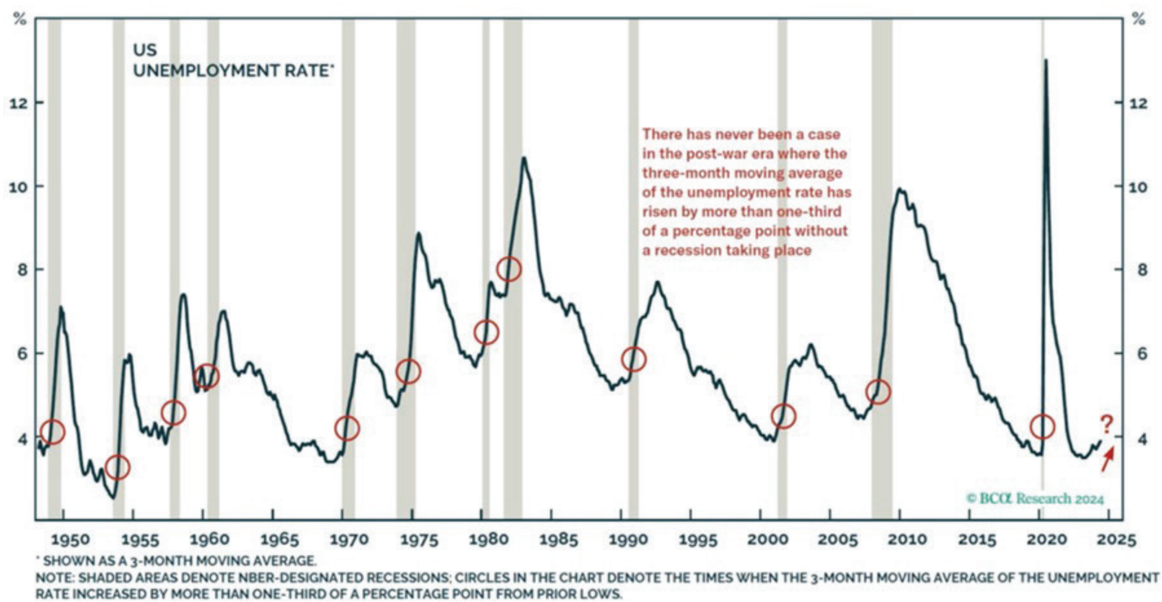

Figure 4 - **US Unemployment Rate**

We also note, that markets usually peak around 6 months before the onset of recession.

So the key question is whether Central Banks are able to cut interest rates as inflation falls back to target, without the economy slowing too much.

INFLATION AND INTEREST RATES

Inflation is trending down in the US (unlike Australia) and while very late to react, the Federal Reserve increased rates significantly higher than the RBA. This gives the Federal Reserve more room to cut, with markets now pricing the probability of the first cut in September now at 85% and a total of 3 rate cuts or around 75bps by January next year. This seems reasonable.

Figure 5 - US Inflation (CPI) and Fed Interest Rate

What happens to interest rates beyond this is far more important for financial market performance. A few rate cuts of circa 75-100bps (i.e. the soft-landing scenario) is already largely priced into bond, equity and credit markets. But, we note that a few rate cuts from the current level will still see much higher average interest costs for both businesses and consumers next year as loans continue to roll off the significantly lower levels seen for the decade prior to mid 2022, where the Fed funds rate averaged well below 2%.

Just as there is a very long lag for the full impact of rate rises to impact the economy, it will also take time for rate cuts to be felt and more importantly we expect interest rates on average to be considerably higher in the 2020's than the previous decade.

The chart below shows the period post the GFC where inflation dropped well below the target 2% level. This was fuelled by a huge deleveraging cycle following the financial crunch and great recession. For over a decade Central Banks were concerned about deflation and consequently engaged in what we consider the failed experiments of zero and in many cases negative interest rates, coupled with enormous money printing.

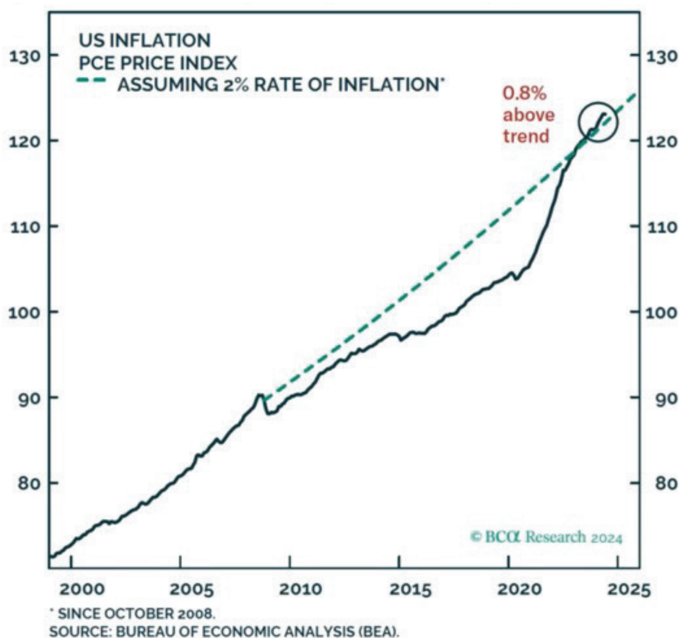

Figure 6 - **US Inflation (PCE Price Index) vs 2% Target**

The huge inflationary surge from 2021 has driven inflation back above the longer-term 2% trend line. We view the period of ultra-low inflation and interest rates of the previous decade as a financial anomaly and believe we have now simply moved back to a more "normal" interest rate environment and do not expect to see a return of sub 2% interest rates. As widely discussed in the adviser roadshows earlier in the year, inflation is likely to remain much higher over the coming decade and we will likely see inflationary shocks (rather than the deflationary shocks of the last decade), driven by the global themes of reshoring and friendshoring (de-globalisation), the very expensive and resource intensive energy transition, coupled with increased defence spending as a result of significantly higher geo-political risk, and the huge stimulatory government deficit spending of the Western World and ever increasing supply of bonds to fund it.

Be careful what you wish for: Historically rate cuts have not been good for share markets.

To drive a meaningful move in financial markets from here, we would need a move in interest rates above what is currently priced (i.e. an interest rate hike, or more aggressive rate cuts). The first scenario would be another inflation shock and result in an increase in interest rates, rather than the expected cuts (which is a possibility here in Australia but not globally). This would in our opinion see a sharp fall in both equity and bond markets. However, we only ascribe around a 10% probability to this stagflation outcome. The second scenario is where central banks are forced to cut far more aggressively which would be because of a far sharper slowdown in economic activity or sharp increase in unemployment.

While markets may initially rally at the prospect of rate cuts, the economic reality of recession and falling corporate earnings would eventually see the resumption of a bear market. We ascribe around a 60% probability to the recession outcome. The final 30% probability is the soft landing scenario where only a few rate cuts are required to take the remaining heat out of inflation and a secular bull market continues. As mentioned earlier, this was the case in 1994, which set up the bull market of the late 90's. But, this is the only example of a soft landing after an aggressive rate hiking cycle. Recessions usually start ***after*** the Fed has started cutting rates.

This cycle however is unlike previous cycles as the world had never engaged in large scale, co-ordinated Quantitative Easing (money printing). Economic theory said that it would end in a painful inflation cycle, though surprisingly, few saw this coming - and even fewer were positioned for it.

Similarly, we don't have a playbook for the unwind and traditional indicators have not worked... so far. The US Yield Curve (2yr/10yr) below, has been inverted for two years now and money supply, which contracted for most of 2023 and into early 2024 is growing again.

Figure 7 - **US Yield Curve (2 year / 10 year)**

Figure 8 - **US M2 Money Supply (yoy % change)**

We often need to remind ourselves however, that the economy is not the stock market and while there are many economically sensitive sectors there can also be powerful structural drivers for regions and sectors of the market. More on this in the markets section.

REST OF WORLD ECONOMIC OUTLOOK

CHINA

China is in a deflationary spiral, similar to Japan after the 80's bubble burst. Issues around the housing market are not improving and despite stimulus efforts by the government continue to deteriorate. Housing starts are 60% below the level of a few years ago, yet prices are still too high (new housing prices are strictly controlled) and the working age population is now declining.

The Manufacturing sector, which has been the other key driver of Chinese growth over the past few decades remains soft. We saw a short-lived bounce in early 2023 when China came out of lockdown and another short lived bounce earlier this year. To stimulate export markets China should allow the currency to depreciate in a meaningful way but won't. Foreign investment capital flows into China have stopped (re-shoring/friend-shoring and increased geopolitical tension with the west) and strict capital controls within China are required to halt domestic outflows. China ultimately wants the Renminbi to become a reserve currency, as an alternative to the USD and seeks price stability.

Like many other regions, the services sector now also looks to be trending down again.

Figure 9 - China Manufacturing and Services PMI

Problems with the Property sector are very well documented and an issue that we detailed back in 2020. We are now seeing the flow on effects of a classic debt fuelled bubble. For instance, in June alone over 40 Chinese banks vanished, as they were absorbed into bigger ones. This is reminiscent of the savings and loans crises in the late 80's / early 90's in the US, spurred by aggressive lending growth, poor risk controls and ultimately a property market downturn. These structural imbalances take a long time to normalise.

June retail sales came in at just 2% growth for the year and as detailed in the chart below, lending growth, a key driver of economic activity remains in a downtrend.

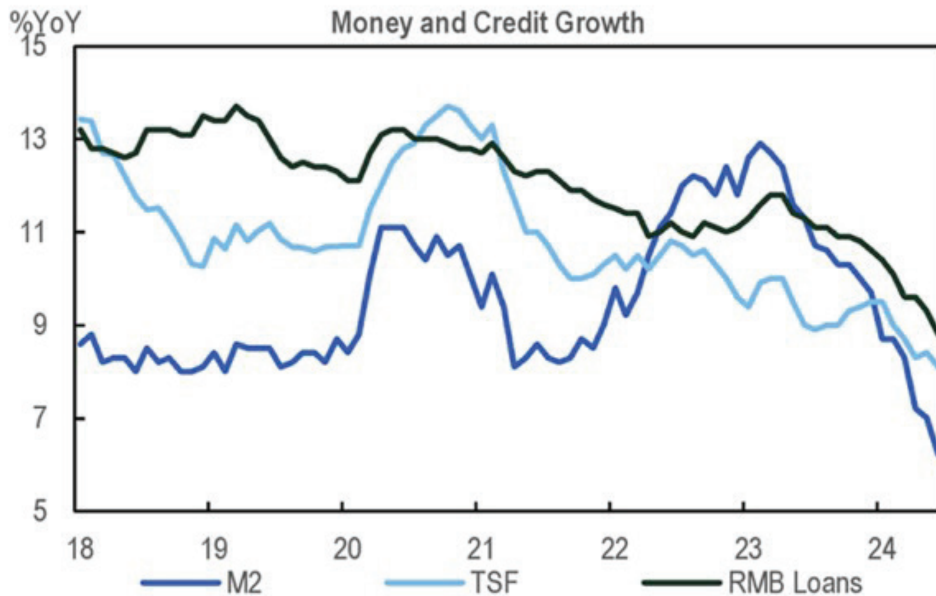

Figure 10 - **China Money and Credit Growth (% yoy)**

We are by no means predicting a collapse of the Chinese economy and note the success that China has made to date in shifting from old economy, low tech, high volume based industry's like steel, aluminium, cement etc to high tech manufacturing like EV's, batteries, solar and even medical devices and equipment. This diversification will however take time and will also become increasingly challenged by trade 'partners' in the US and Europe.

INDIA

Other regional markets like Vietnam and India have benefited significantly from these shifting supply chains. In terms of size, India's economy is only 20% of the size of China's, but it is growing at a faster rate and has a young, well educated and growing workforce and according to IMF estimates could overtake China by 2050. While these characteristics have been the case for a long time, India previously lacked the infrastructure to unlock its growth potential and attract meaningful foreign investment capital. The Modi government, which was narrowly re-elected will likely redouble their focus on growth rather than shift toward redistribution and continue the significant structural reform agenda with a continued focus on infrastructure development. Indeed we have seen considerable investment in China over recent years by almost all of the magnificent seven group of companies. Citigroup expect GDP growth of 6.8% and 6.5% over the next two years and nominal GDP growth in the low teens. This makes for an interesting longer term investment thematic (at the right price) and one we are actively reviewing.

EUROPE

The broader Eurozone now looks to have stabilised with recent data indicating a mild pick-up in activity. After the energy shock of 2022 and avoidance of a widely expected economic collapse, the economy, currency and markets have all normalised. We slightly increased exposure to Europe during this weakness and also moved the European exposure to fully unhedged following the Russian invasion (as shown in the chart below).

Absent a US recession, the overly governed, overly regulated and overly bureaucratic Europe Union will return to what seems to be its natural low growth state. Like Australia, China will not be a short term driver of increased demand in Europe and we have recently seen softer results from a number of the high end luxury brands like LVMH, citing a weak Chinese consumer. The shifting political landscape in Europe will be fascinating to watch, but not likely to change the broader economic landscape in the short term.

With a slower China, if the US enters recession Europe will almost certainly follow suit.

Figure 11 - Euro AUD Currency Exchange Rate

JAPAN

The Japanese economy and market are currently beating to a different drum. While the rest of the world is moving to an interest rate easing cycle, the BOJ is only just starting to move rates off the floor after almost three decades!

We have warned of the deflationary spiral that China appears to be entering, which has been termed the "Japanification of China". Japan was the epicentre of the excesses of the 1980's and when the bubble burst, endured a multi decade deleveraging/deflationary cycle. This cycle has now ended, with the Japanese economy (excluding the last two quarters, which contained some aberrations) now on a stronger growth footing and inflation back above 2% from early 2022. Japanese Corporations have also undertaken significant reform, dating back to 2015, focused on increasing return on equity and shareholder returns via buy-backs and increased dividends. The Japanese stock market has been the best performing market over the past few years, even outpacing the S&P 500, but, has only just recovered the previous 1989 high (chart below).

Figure 12 - Japan Nikkei 225 Equity Market Index

We retain an overweight position to Japan and will likely increase exposure when we are again allocating to equities. Despite the strong performance of late, Japan will also continue to benefit from current geopolitical tensions and the trend toward 'friendshoring', and will remain a leader in tech and robotics, which not only benefits from the West onshoring manufacturing, but also from the broader AI thematic. With the Japanese market still trading at a forward P/E and P/B ratio of 15.6x and 1.3x, compared to 20x and 3.2x for the MSCI World, Japanese equities appear well positioned in this cycle for further growth and if the event of a broader economic downturn materialises, the Japanese Yen will likely provide a defensive buffer.

AUSTRALIA

The Australian Economy is on the brink of Stagflation. We have large, now structural wage increases, with declining productivity. In May the annual rate of inflation rose to 4% from 3.6% in April while economic growth was just 0.1% in the first quarter of 2024 despite record levels of immigration. The Tax cuts coming into effect this month are meaningful and amount to approximately $23bn or almost 1% of GDP. This may provide a minor boost to spending but we suspect will largely be absorbed by the general rise in cost of living expenses. We do not expect inflation to reach the RBA's target range for at least 12 months making it very difficult for the RBA to ease policy.

Like the US, while on the surface the employment market looks strong, more forward looking indicators like job ads have softened considerably. The ANZ Job data showed national job ad volumes fell 17% year on year in June. This was a slight improvement on the 18% and19% falls in May & April, however sequentially momentum remains very negative. Furthermore, the bulk of jobs growth has been in the (already bloated) public sector which is unsustainable given current debt levels and budget deficits of the East Coast State Governments. Here in Victoria we are now starting to see significant cuts to public services spending and the reining in of the out of control infrastructure project spending. We are hopefully through the peak of government largess but will now suffer the consequences of gross financial mismanagement for years to come.

Small business, which is the lifeblood of the economy, is challenged. Corporate bankruptcies rose 32% last financial year to almost 11,000, albeit with a large bias to the construction and hospitality sectors.

I expect that we will see a period of below trend growth in Australia for the next few years.

MARKET PERFORMANCE AND POSITIONING

EQUITY MARKETS

Most equity markets delivered strong returns last financial year with the MSCI All Country World index up 21.3%. The strongest performing market as highlighted was Japan, followed closely by the US. Within the US market, the tech-oriented Nasdaq returned just over 30% thanks to the mainstream break out of the Artificial Intelligence Thematic (more on this later). The worst performing market was China, which was not surprising.

Total Returns June 2024	1 Month %	3 Months %	6 Months %	1 Year %
Local Currency				
MSCI Australia	1.6	(0.7)	4.7	13.8
MSCI AC World	2.6	3.5	13.5	21.3
MSCI USA	3.6	4.0	14.9	24.7
MSCI Canada	(1.6)	(0.9)	6.0	13.2
MSCI United Kingdom	(1.0)	3.6	7.8	13.2
MSCI Europe ex-UK	(1.5)	0.6	10.3	13.7
MSCI Japan	1.7	1.8	21.5	26.4
MSCI Emerging Markets	4.3	6.3	11.2	16.0
MSCI China	(1.9)	7.1	5.2	(1.7)
MSCI Korea	8.2	1.2	7.6	13.4
MSCI Latam	(0.6)	(3.9)	(6.0)	6.0

Figure 13 - **Regional Equity Market Total Returns (June 2024)**

While the economic commentary above is certainly on the cautionary side, we have not been long term bears and bought the market dips in 2022 and 2023. As markets priced a hard landing twice in 2022, we argued that it was too early to position for recession given the extent of stimulus and the length of time it would take monetary policy to soften demand. Now, two years on, markets have priced a soft, or even a no landing scenario which we are concerned about and are positioning for a potential recession. ***As we have stated many times, being positioned for the Consensus view usually leads to underperformance.***

The majority of markets and asset classes are not pricing in any meaningful macro risk. They also appear to be largely ignoring what seems to be the highest level of Geopolitical Risk for decades.

AUSTRALIAN SHARE MARKET

We scratch our heads at current market valuations in Australia and have continued to reduce positioning. The ASX 200, which recently breached the 8,000 level for the first time, is expensive on almost every metric. PE of almost 17x 2025 earnings forecast, dividend yield of 3.6% (below the cash rate), Price to Book value at 2.09 etc. Commonwealth Bank just became our largest company, and while it is clearly the highest quality of the big four banks, it is trading on almost 23x earnings. By their own forecasts CBA will not likely grow earnings over the next two years. Our valuation is in the $105-$110 range, some 20% below the current share price.

The chart below shows the ASX 200 in blue with underlying earnings forecasts in red. The current period circled in green to us resembles the period leading up to the 2020 Covid correction, where the economic and earnings environment was deteriorating but markets continued to rally on Fed rate cut expectations (after the Bernanke pivot in February 2019). We continued to reduce exposure over this period with an expectation that recession was likely. We will never know the outcome absent Covid, but are confident in the knowledge that markets always mean revert over time.

We have an environment today where the economy is teetering, earnings are declining but markets are rallying, again with a view that rate cuts will usher in a new growth cycle. This, in our opinion, leaves an air pocket or gap between valuation and earnings of some 10%-20%.

Figure 14 - Australia ASX200 Equity Market Index vs Forward Earnings Estimates

With the current macro backdrop, one would not expect the banks to perform, yet they were the strongest sector for the year returning over 30% including dividends. This remains our largest underweight and hurt performance for the year. Telecoms, Utilities and Consumer Staples, which are defensive sectors, were the worst performing sectors. Our market is very much positioned for a soft or no landing scenario, with an accelerating economic and earnings outlook off the back of lower rates in 2025 and beyond. This presents a risk.

We also saw the large cap stocks (top 50) significantly outperform the broader market, which to us indicates large foreign buying of the Australian market thanks to the mother of all carry trades - very cheap funding from Japan which still has a cash rate near zero, into higher yielding assets abroad. As mentioned above though, this can unwind just as quickly in a risk off environment (reversal of the Yen) or progressively as the developed world cuts rates later this year and into 2025 while Japan hikes.

Our Equity SMA's are near cash maximum limits, with net market exposure in the Australian Share SMA (accounting for the short position) of just below 70%, a cash weight in the Emerging Leaders SMA of 31%, 17.4% in the International Share SMA (with assets in USD) and net market exposure in the ex-US International ETF sleeve also near 70%.

By derivation the Multi-Asset portfolios are currently significantly underweight equities, with the Balanced at 46% vs the 60% neutral setting (Growth at 60.4%, High Growth at 67.7% and Conservative at 31%).

THE US SHARE MARKET: US EXCEPTIONALISM, THANKS TO THE MAGNIFICENT 7 (OR 6 OR 5)

The US share market performed strongly again this year as it has almost every year in recent history, outside of 2022, thanks to the Magnificent Seven companies: Apple, Amazon, Google (Alphabet), Microsoft, Meta (Facebook), Netflix and now Nvidia. Earnings in the US rose over the past year, unlike in Australia and most of the rest of the world, but this was largely due to the exceptional results of the Magnificent Seven, who now account for approximately 30% of the S&P 500 index.

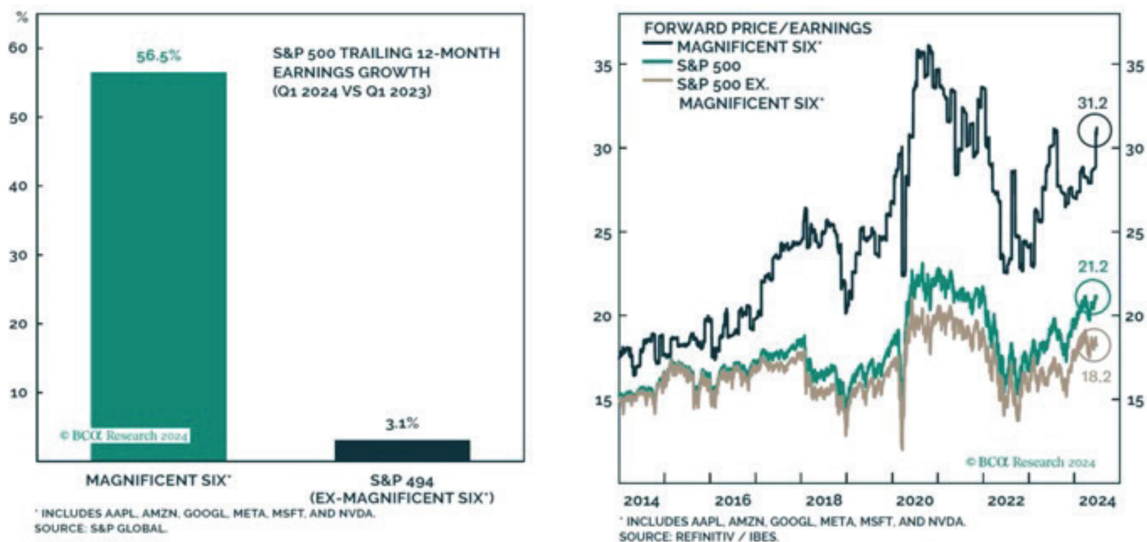

Figure 15 - **US S&P 500 Trailing 12-Month Earnings Growth and Forward P/E Ratio ('Magnificent 6' vs Rest of Index)**

These are truly great companies, five of which are held in our International Share SMA with a combined weight of just over 30%. We agree, that in the short term they are very fully priced, and in the short term the hype around AI may be a little premature, but this is a sector that we want to add to in weakness. The monstrous investment in AI will garner both winners and losers and it will take time to see meaningful return on the estimated $1tn spend. But it will be truly transformational to most industries over time and the big global tech players are best positioned to capitalise. Microsoft has already rolled out Co-pilot as an option across its Office software with the potential to double revenue per user and Cloud services across Amazon, Microsoft's Azure and Google Cloud will provide AI enabled services to customers across almost every major industry (think healthcare, defence, retail etc).

If we think about Apple, which has 1.2bn connected devices, AI will not only drive an upgrade cycle for Apple devices, but will drive substantial services growth with the development and rollout of AI enabled apps as a service. The major beneficiaries of the initial phase have been the hardware manufacturers, namely the chip manufacturer Nvidia, but the second phase will be driven by the software developers and subsequent applications.

Outside of the tech companies in the US, we also saw very strong performance from the financials, JP Morgan, Wells Fargo and Bank of America and disruptive retailer Costco.

Comparatively, JP Morgan delivered low double-digit earnings growth and is trading on 12x earnings vs Australian banks, with falling earnings and trading on 15-16x earnings or CBA on 23x.

Future equity investment will likely have a bias towards US equities (and select overseas markets like India and Japan) or domestic equities with global earnings that can structurally grow in a more difficult economic environment.

FIXED INCOME

The Watershed Income SMA generated a return of 7.21% excluding franking credits last financial year. A pleasing result given the RBA cash rate returned 4.24% and the Global Aggregate Corporate Index (global fixed rate index) returned 6.81%. We had no exposure to Developed Government Bonds coming into the sharp 2022 re-pricing of interest rates and have since continued to buy the bond markets dips, increasing exposure to 29.45% currently.

Over the past year we have increased our exposure to US Treasuries but not Australian Government Bonds given the higher yield on offer and scope for better capital appreciation as rates move back towards the "theoretical" neutral level. In a recession scenario, we see scope for the Fed to cut the funds rate from the current 5.25%-5.5% range, to 2% which would likely see the 10 year bond yield fall from 4.23% today to around 3%. It peaked at 5% in October last year. We will likely continue to increase US Treasury exposure, funded from credit and floating rate notes, particularly if we see data continuing to soften. We are actively reducing credit, particularly high yield credit, which has been a very strong performer over the past year but is now very fully priced, with credit spreads (chart below) back near record lows.

Figure 16 - Bloomberg Corporate Average Credit Spreads

The floating rate Bank Hybrid component within the portfolio, which has also been a very strong performer now sits at 46.4% and has been a funding vehicle for duration. While we are very uncomfortable with the level of Bank share prices, their credit quality today is better than it has ever been and significantly stronger than pre GFC (with more risky lending having been pushed out of the banking system to the rapidly growing Private Credit sector (more on that below). Tier 1 capital levels sit at 12.3% (CBA), 12.15% (NAB), 13.5% (ANZ) and 12.55% (WBC). Hybrid margins are now lower than we would like but sit above the BBSW rate of 4.48% today, providing yields of 6.5%-7%. Rate cuts in Australia have been pushed out, but as they get closer, we will continue to rotate into fixed rate government bond exposure in Australia.

I am asked regularly about Private Credit Funds which returned 9%-12% last year and have exploded in number and size. It is a sector that we have successfully invested in previously and like all asset classes there will be good and not so good managers across the space. At this stage of the economic cycle however we remain cautious and note that some cracks have started to appear, with a number of large corporate defaults; Healthscope, Bonza and Genesis Healthcare for example which were all funded by private credit. We expect to see some lock ups and some loss of capital in an economic downturn and avoid the space for now.

In summary, we remain active, have significant firepower to buy any dislocations but will also be quick to pivot if warranted. Being surprised to the upside, like the V-shaped recovery coming out of Covid, is always more pleasant!

A THANK YOU

Finally, I would like to thank all of the advisers choosing to use Watershed Funds Management. Our business turns 15 years old this month. We take the role as custodian of your client funds very seriously and look forward to what will no doubt be another fascinating year in financial markets.

Adrian Rowley
Chief Investment Officer
25 July 2024

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