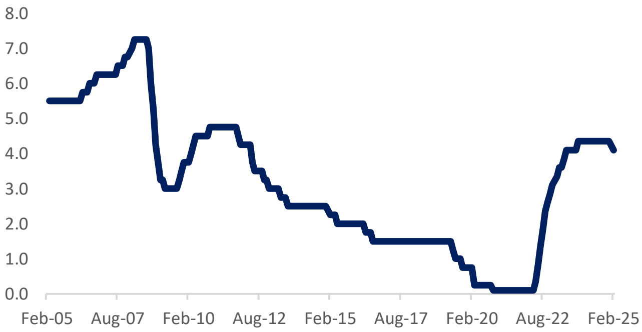
Investment Newsletter – February 2024

RBA cuts the cash rate by 0.25%…

Welcome to the February 2025 letter.

RBA cuts the cash rate. The Reserve Bank of Australia (RBA) has delivered its first interest rate cut of 0.25% since it began its tightening cycle in 2022. Relative to most of its global peers in other developed markets, RBA is probably the last central bank to begin its easing cycle. However, the interest cut was accompanied with comments from the RBA Governor Michele Bullock that the market shouldn't assume more rate cuts in 2025. That the current rate cut expectations of three in 2025 may be too many.

Figure 1: RBA cash rate (%)



Source: Banyantree, Bloomberg, RBA

Coming in for a soft landing. It appears the RBA has manufactured a "soft landing" for the Australian economy through a myriad of risks – RBA cash rate increasing from 0.1% to 4.35% over a 18-month period, significant amount of Australian mortgagees shifting from fixed rate mortgage to variable rates, a massive spike in inflation & bringing inflation back towards the bank's target rate, not causing a major spike in the unemployment rate, geopolitical tensions from abroad and avoiding a recession. While it appears, we have avoided an economic calamity, the Australian economy hasn't come away completely unscathed. The economic growth is sluggish, productivity growth is non-existent and real economic growth rate over the next two years is forecast to be a touch below 2.0%.

Did the RBA need to cut? According to Governor Bullock comments following the rate cut decision, it was a close call whether to cut or remain on hold. The RBA could have easily remained on hold.

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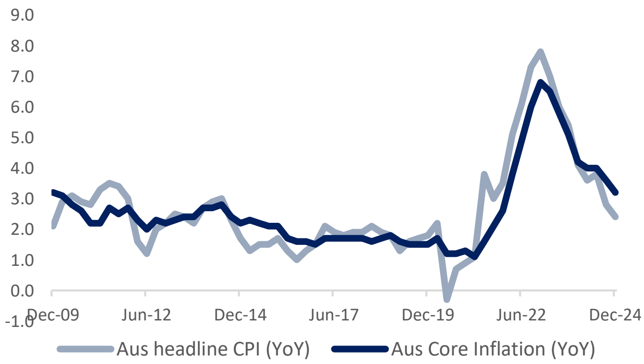
Figure 2: Australia headline vs core inflation (%)

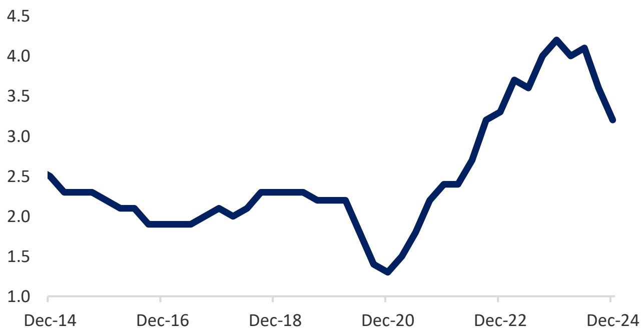


Source: Banyantree, Bloomberg, RBA, ABS

Firstly, while the headline inflation rate of 2.4% now sits within RBA's target range of 2-3%, the core inflation reading of 3.2% remains above the target range. Secondly, while we are cognizant the share market is not necessarily a reflection of the real economy, nonetheless the S&P/ASX 200 is trading on a forward price-to-earnings multiple of 18.5x and dividend yield of 3.3% - both well above their respective long-term average. These valuation metrics don't suggest to us that "animal spirits" are missing. Evidently, the consumer and economy are sluggish but muddling through. If the RBA miss-times the rate cutting cycle, it potentially invites back speculative behaviour (including the property market) and the threat of inflation reaccelerating.

However, there is one economic indicator that does support the RBA's rate cut – that is Australian wage growth. Wage growth in Australia is starting to moderate from its peak which does support the case for lower inflation ahead and therefore gives the RBA room to begin the easing cycle.

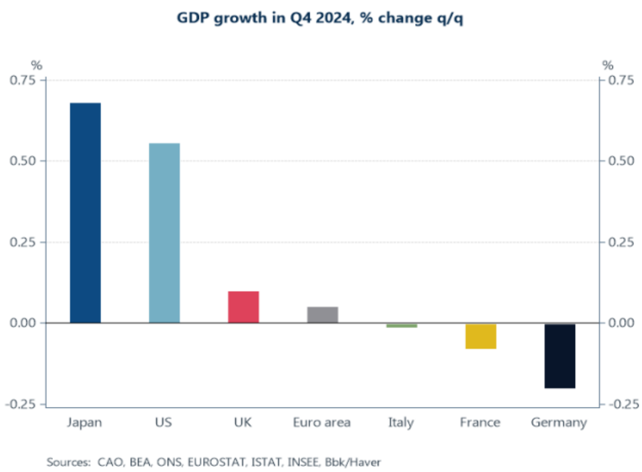
Figure 3: Australian wage growth YoY (%)



Source: Banyantree, Bloomberg, RBA, ABS

U.S. growth concern. In terms of global growth, Japan and the U.S. delivered strong growth in the fourth quarter of CY24. While Europe continues to struggle, with Germany standing out as a major concern. In recent days, economic data out of the U.S. was also on the soft side. Recent movements in the markets – such as bond yields rallying, defensive sectors healthcare & consumer staples outperforming technology – could suggest investors are moving from inflation concern to growth concern.

Figure 4: 4Q24 GDP growth in selected major economies



Source: Haver Analytics, Banyantree

GLOBAL MARKETS OVERVIEW

		Month End	Price Performance (% Chg)			
	Units	Value	1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	8,532	0.45%	4.57%	5.44%	11.09%
ASX 200 Futures	AUD	8,507	0.56%	4.41%	4.99%	12.21%
Dow Jones	USD	44,545	-0.75%	4.70%	9.06%	16.76%
S&P 500	USD	6,041	-0.50%	2.70%	9.38%	24.66%
Stoxx Europe 600	EUR	540	0.13%	6.29%	4.12%	11.09%
FTSE 100 (UK)	GBP	8,674	0.31%	6.13%	3.66%	13.67%
DAX (Germany)	EUR	21,732	0.02%	9.16%	17.42%	28.56%
CAC (France)	EUR	7,950	0.11%	7.72%	5.56%	3.83%
Nikkei 225	JPY	39,572	0.15%	-0.81%	1.20%	9.06%
Emerging Markets Equities						
MSCI Emerging Markets	USD	1,093	-0.22%	1.66%	0.79%	12.05%
Shanghai Composite	CNY	3,251	0.00%	-3.02%	10.61%	16.57%
South Korea	KRW	2,517	-0.77%	4.91%	-9.14%	0.81%
Taiwan	TWD	23,525	0.00%	2.13%	5.97%	31.50%
Brazil	BRL	126,135	-0.61%	4.86%	-1.19%	-1.27%
South Africa	ZAR	77,802	0.42%	3.21%	2.83%	14.36%
Foreign Exchange						
AUDUSD	Currency	0.6218	0.14%	0.48%	-4.95%	-5.33%
AUDGBP	Currency	0.5012	0.22%	1.34%	-1.51%	-3.18%
AUDEUR	Currency	0.5994	0.30%	0.28%	-0.81%	-1.27%
AUDCNY	Currency	4.50	-0.19%	-0.19%	-4.76%	-4.76%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,594	-1.24%	1.67%	13.25%	13.77%
LME COPPER 3MO ($)	USD/mt	9,048	-0.88%	3.19%	-1.92%	5.11%
LME NICKEL 3MO ($)	USD/mt	15,210	-1.20%	-0.77%	-8.40%	-6.51%
SILVER FUTURE Mar25	USD/oz	32.27	-0.70%	10.34%	8.35%	32.78%
ICE Newc Coal Fut Mar25	USD/mt	121.90	1.46%	-5.58%	-17.02%	-0.37%
62% Import Fine Ore in USD	USD/t	99.80	0.00%	4.67%	4.57%	-21.45%
Gold Spot $/Oz	USD/oz	2,798	0.14%	6.63%	14.33%	37.21%
WTI Oil	USD/bbl	72.53	-0.27%	1.80%	-2.07%	1.23%
Henry Hub	USD/mmBtu	2.92	-6.41%	-14.12%	50.98%	33.33%
Corn	USD/Bu	482.00	-1.68%	5.13%	25.93%	7.53%
Wheat	USD/Bu	559.50	-1.24%	1.45%	6.12%	-6.01%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	4.43%	+0.05%	+0.07%	+0.31%	+0.42%
US	USD	4.54%	+0.02%	-0.03%	+0.51%	+0.63%
Germany	EUR	2.46%	-0.06%	+0.09%	+0.16%	+0.29%
Japan	JPY	1.25%	+0.03%	+0.14%	+0.19%	+0.51%
Italy	EUR	3.55%	-0.05%	+0.03%	-0.10%	-0.18%
Australian Rates						
Cash Rate	AUD	4.35%	+0.00%	+0.00%	+0.00%	+0.00%
90-Day BBSW	AUD	4.25%	+0.01%	-0.15%	-0.16%	-0.08%
180-Day BBSW	AUD	4.31%	+0.00%	-0.18%	-0.35%	-0.08%
CBOE Options						
CBOE VIX (Volatility Index)	Index	16.43	3.72%	-5.30%	0.43%	14.49%

Data as of 31 January 2025

ECONOMIC NEWS

• **Australia**. Both consumer and factory inflation eased more than expected in 4Q24 with CPI up +2.4% y/y, core CPI up +3.2% y/y and PPI rising +3.7% y/y (+0.8% q/q). Consumer confidence edged down in January on concerns about the broader economy, including a weaker currency and uncertainty about the timing of interest-rate cuts. Australian house prices slid further in January with the Home Value Index for major cities falling -0.2% in its second straight monthly decline, as buyers in the triangle of Melbourne-Canberra-Sydney found themselves increasingly priced out of those markets with Melbourne leading the losses, dropping -0.6%, followed by Canberra at -0.5% and Sydney down -0.4%.

• **U.S.** The Fed voted unanimously to keep the federal funds rate unchanged in a range of 4.25-4.5%, with officials repeating that inflation remains “somewhat elevated” and removing a reference to it having made progress toward their 2% goal as the officials look to evaluate the impact of President Donald Trump's policies on the economy and to wait for further evidence of cooling inflation before adjusting rates again. The Fed Chair Jerome Powell noted that the Fed is in no hurry to lower interest rates, citing a strong economy and a need to see further progress on inflation. Factory activity expanded in January for the first time since 2022 as orders ramped up and production quickened with a measure of new orders rising for the fifth straight month to deliver the strongest growth since May 2022 and production gauge moving solidly into expansion territory to deliver the best reading since March 2023, however, producers continued to contend with elevated costs with a gauge of prices paid rising to the highest since May 2023. Business activity expanded in January at the slowest pace in nine months on a pullback in the pace of growth at services providers partially offset by growth in manufacturers with manufacturing index moving back into expansion territory with output, orders and employment now showing growth on improved domestic demand with businesses continuing to express optimism about future demand, which matched the highest level since May 2022, however, inflationary pressures continued to increase with the composite measure of prices paid for materials climbing to a four-month high, index of prices received rising to the highest since September, output prices at manufacturers rising to an almost one-year year, while a gauge of prices charged by service providers advancing to a four-month high.

• **China.** Economy grew more than expected in 2024 on a late policy blitz and export boom, with GDP rising +5.4% y/y in 4Q24, marking the fastest pace in 6 quarters, bringing the 2024 growth to +5% y/y, however, once adjusted for falling prices, nominal GDP expanded only +4.2% in 2024, the slowest since the economy opened up in the late 1970s barring the pandemic slump. Government failed to meet its spending target last year with total augmented spending of 38.6 trillion yuan for 2024, -5% less than what was budgeted in March, as the housing market slump left local governments strapped for cash and unable to meet funding commitments, with augmented fiscal revenue of 28.2 trillion yuan during the year, resulting in a deficit of 10.4 trillion yuan, equivalent to 7.7% of GDP.

• **Europe.** ECB lowered borrowing costs for the fifth time since June, reducing the deposit rate by -25bps to 2.75%, and signalled that more loosening is in the pipeline, with President Christine Lagarde describing the current monetary-policy stance as "restrictive" while announcing disinflation “is well on track” with most measures of underlying inflation suggesting that inflation will settle at around the target on a sustained basis. Euro zone economy unexpectedly stagnated in 4Q24 as government collapses in Germany and France bruised confidence among businesses and consumers, equating to total growth in 2024 of +0.7% y/y.

• **India.** Government announced a record $11.5bn in tax cuts in its latest budget, which will spare 10 million more Indians from income tax and provide relief to the middle class, along with other measures including new subsidies for farmers and tariff reductions, forecasting total expenditure in the financial year ending March 2026 to total 50.7 trillion rupees with FY25 fiscal deficit target seen at 4.8% of GDP and FY26 fiscal deficit target forecasted at 4.4% of GDP. Government predicted the economy will expand 6.3-6.8% in the coming fiscal year, significantly below the levels it says are needed for Prime Minister Narendra Modi to meet his ambitious economic goals of making the country a developed economy by 2047 for which it needs to grow at around 8% for about a decade or two.

• **Japan.** BOJ raised its key policy rate by +25bps to 0.5%, the highest level in 17-years and made a significant step toward shrinking its massive balance sheet by announcing phasing out its fund-provisioning program. BOJ raised its 2024, 2025 and 2026 CPI forecasts to 2.7%, 2.4% and 2.0%, respectively, while lowering 2024 GDP growth outlook by -10bps to +0.5% and maintaining 2025 and 2026 forecasts of +1.1% and +1%, respectively.

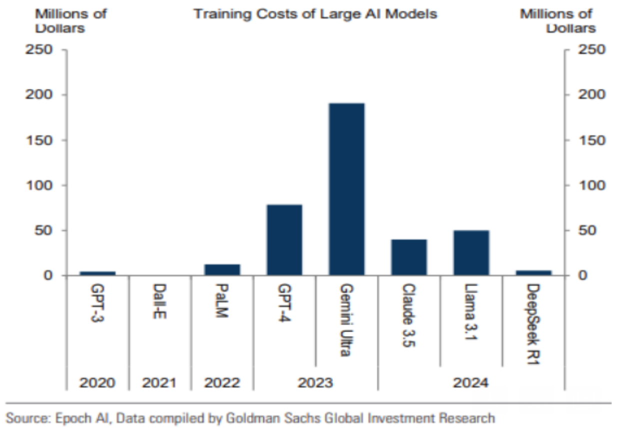
THE LONG READ

China's DeepSeek – "It caught us by surprise"…Really?

A Chinese artificial-intelligence (AI) startup DeepSeek – which mind you is a little over one year old - has caused a massive stir in global financial markets and led to a material de-rating in U.S. technology stocks in Silicon Valley. In short, the startup is providing comparable performance to U.S. competitors at a fraction of the development cost.

Why so surprised? Before we get into what DeepSeek is all about I must say I am a little surprised at comments from some investors such as "DeepSeek came out of nowhere" or "it has caught us by surprise". Whilst I am not for one moment suggesting we personally had advanced insights into the imminent release of a very competitive AI model by any Chinese startup, what we can say with confidence is that we have been stating for some time now that any global effort led by the U.S. to interrupt innovation and progress in China will be futile. Restrictions of advanced semiconductors and critical minerals to China of course moderates the speed with which China can compete with the U.S. on AI. However, it cannot stop China's progress as some have expressed to us. DeepSeek sending a shock across global markets and evaporating billions of dollars in market capitalisation off U.S. listed AI companies validates our view.

Figure 1: How cheap is DeepSeek in terms of trading costs?



Source: Goldman Sachs

What is DeepSeek? DeepSeek develops open-source models (open to anyone to inspect and build on) and is like OpenAI's ChatGPT or Meta Platforms (Facebook) AI. DeepSeek's R1 reasoning model – which attempts to replicate human thinking - allows individuals developing chatbots to use its technology at a price which is below what OpenAI charges for services. According to reports, DeepSeek's R1's performance is on par or exceeds that of rival models on industry benchmarks such as AIME 2024 for mathematical tasks and AlpacaEval 2.0 for question-and-answer performance. Further, the costs to train and develop DeepSeek's models is materially less than that of competitors OpenAI and Meta Platforms' products.

Why has DeepSeek caused such a stir? There are few elements to this.

Firstly, as stated above it brings into question all the effort exerted by the U.S. to try to curb China's technological advancements over the past 2-3 years. To exactly stop China from releasing something like DeepSeek. In our view, the Chinese government is probably involved on some level with providing resources and funding to DeepSeek.

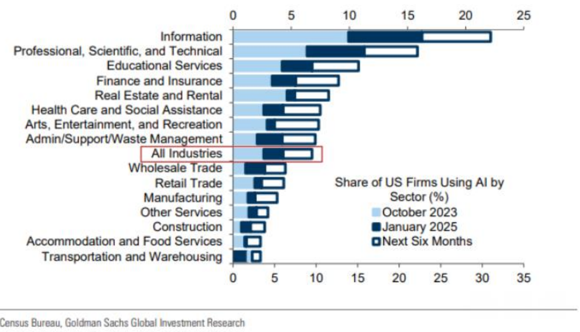
Secondly, and importantly, the fact DeepSeek is much cheaper brings into question the large capital expenditure numbers touted by wall street analysts and companies to acquire powerful AI technology. For example, technology companies such as Microsoft and Meta Platforms (Facebook) have reportedly committed more than US$65bn each this year, largely focused on AI infrastructure. The flow on from companies potentially not having to spend as much on AI infrastructure potentially means lower demand for chipmakers like Nvidia and lower energy consumption requirements.

Thirdly, AI represents an important growth frontier in the battle for global supremacy between China and the U.S. We have long argued China has the human capital and intellect to compete with the U.S. Which is why the background of DeepSeek's founder is worth mentioning. Liang Wenfeng founded DeepSeek in 2023 and is an engineering graduate who has never studied or worked outside of China.

Are there any benefits from the emergence of DeepSeek? Over the long-term the emergence of new and cheaper options will be a positive for economic growth, in our view. DeepSeek indicates to us that more credible competitors to U.S AI companies are likely to emerge. This is positive for at least two reasons – more competition makes the existing players lift their performance and increased competition could lead to faster adoption rates which invariably should drive productivity gains.

Long-term the potential for adoption rates to increase across industries should be a positive for growth. Current adoption rates in the U.S. remain - only 6% of companies reported using AI in regular production

Figure 2: AI adoption rate by industry in the U.S.



Source: Goldman Sachs

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