Monthly Market Commentary

July saw a spike in equity market volatility as a pronounced rotation away from the crowded AI/mega-cap trade tech assets drove performance in small-caps and non-Tech.

Helping fuel some of this were signs of cooling inflation and weakening employment trends which catalysed a rotation into companies with higher margins/returns, solid balance sheets, lower sales variability and those that are less reliant on strong forward growth to justify valuations. Contributing to market volatility was also systemic fund selling, unwinding of carry trades, covering amongst short volatility strategies and general fears of a recession as more signs emerge of a broad-based slowdown.

As bottom-up analysts our key focus is on company dynamics with numerous results during earnings season highlighting just how quickly economic momentum has moderated. We would note that one of the world's largest alcohol companies, Diageo, warned that consumers are facing an "extraordinary environment" reporting its first drop in sales since 2020. US banks have also raised concerns about bad debts, particularly on commercial loans and lower income customers. Interestingly, there also appears to be a squeeze developing in the higher income brackets, with LVMH reporting Q2 organics of 1% vs consensus of 3%.

Cyclical pressures have also weighed on mega-cap tech names, with share price weakness exacerbated by already high starting valuations. For example, Alphabet saw its shares fall 5% on disappointing YouTube revenues with management also flagging margin pressure from rising depreciation. Tesla also delivered disappointing results with shares down 12% after the company announced product delays and lower auto margins on higher costs and discounting.

US small caps were the standout performers in July. The S&P600 Small Cap Index rose 10.7%, well ahead of its large cap peers, the S&P500, up 1.1%, and the NASDAQ which fell 0.8%. European markets fared generally better led by the UK FTSE, up 2.5%, followed by the German DAX, up 1.5%, while political uncertainty weighed on the French CAC40, finishing up 0.7%.

Asia was weaker with ongoing issues in China's real estate sector and spill-over risk driving the Shanghai Composite Index lower by 1%. Japan's Nikkei225 was also lower, falling 1.2% in local currencies, on the back of a soaring JPY which finished up 6.5% against the USD thanks to an interest rate hike by the BOJ and anticipated cuts at the US Fed.

Performance at a sector level reflected this rotational shift with Tech and Communication Services down 2.1% and 3.2%, respectively, courtesy of their outsized exposure to previous favourites. Utilities and Financials were stronger, up 6.5% and 5.7% respectively while Industrials also delivered solid performance, up 4.6%.

The AUD fell 1.9% against the USD as the Bloomberg Commodity Index declined 4%. WTI Oil was also lower, falling 5% in July. As noted above, volatility spiked in July with the VIX rising 3.9 points to close at 16.36, while yields on 10yr US Treasuries fell 37bps to 4.02%.

The Fund's holdings in pharmaceutical majors Roche, Gilead, Johnson & Johnson, and Sanofi were the four biggest contributors to performance, in that order. While all benefitted from sector rotational dynamics, Roche and Gilead were particularly strong on encouraging new drug updates. Namely, Roche's new weight-loss pill, and a Gilead treatment which showed 100% effectiveness in preventing HIV infections in women.

In terms of laggards, employee benefits and rewards group, Pluxee was the biggest drag on performance as a poorly received Q2 result and regulatory concerns weighed on shares. However, given its highly cash generative business model, structural growth attributes and some decent valuation support (stock trading on 12x FY25 EPS), we will continue to hold.