Portfolio Perspectives

Insights from the CIO Office

October 2023

In brief

- *We believe an apparent imbalance between the supply and demand of US government debt could lead to higher long-term interest rates regardless of the inflation path. For defensive allocations, we prefer Australian long-term bonds over the US equivalent.*
- *We believe the key drivers of Australian inflation are largely outside of the Reserve Bank of Australia's influence, meaning it is uncertain whether they will keep raising interest rates. This keeps us neutral on Australian Equities.*
- *The persistent underperformance of China's equity market has extended to where we now believe the balance of outcomes justifies removing our underweight call to Emerging Markets*
- *We believe the general interest rate environment will be flat, with the potential for higher interest rates in the near term. This environment has historically been challenging for interest rate-sensitive equities*.

Over the last month, three key issues have been front of mind for Lonsec's CIO Office:

1) US debt seems to be receiving a response from the bond market

2) Australian inflation that is not playing by the rules

3) General recession risks

US CPI inflation has steadily decelerated since June last year and yet, the US Government's 10-year bond yield has steadily increased over this same period. Even in the previous six months, when the market ignored the risk of runaway inflation, the yield continued to rise. We believe the bond vigilantes of the 1980s might be back, demanding higher yields from the risks of unrestrained government spending.

As noted by the US Congressional Budget Office when discussing the outlook for the US deficit, the projected size of the deficit has only been at such levels during WWII and the coronavirus pandemic. Yet a glance around the world today fails to identify an existential threat to our species that would warrant such largesse by the US government. To be clear, the fiscal path does not assume the extension of the 2017 Trump Tax cuts, which will expire in 2025, meaning this fiscal largesse spans both aisles of politics. More alarming (as noted by Apollo*) is that over the next 12 months, approximately 31% of ALL US government debt (~US$7.6 trillion - nearly 5x the size of the entire Australian economy) must be refinanced. This comes as the three biggest owners of US debt have changed course. China has steadily reduced its holdings of US debt for the past several years. High hedging costs dissuade Japanese buyers from buying any more US debt. The US Federal Reserve has flipped from Quantitative Easing to Quantitative Tightening, meaning they are reducing their holdings in US debt.

We believe this is a classic imbalance between supply and demand where the price (in this case, the yield) must adjust to bring the market into equilibrium. As the market is more supplied with debt, buyers are demanding higher yields for taking it on. Unrestrained deficit growth is not sustainable, and curtailment must happen eventually. However, given that the US presidential elections are due in November 2024, it seems unlikely the market will see any presidential candidate campaign on a platform of tax increases and/or benefit cuts. In the meantime, we believe the path for US long-term interest rates is up regardless of what inflation might do from here.

The takeaway for investors is to consider Australian government debt in their defensive allocations. Contrary to the growing supply of

US debt, Australia had a budget surplus in 2023 and is forecasted to do so again in 2024. A surplus leads to no new debt supply and the repayment of existing debts. A lack of supply might already contribute to the Australian government's 10-year yield being below its US equivalent, an exceedingly rare event.

A critical debate within the CIO office is how the Reserve Bank of Australia (RBA) will deal with inflation pressures largely immune from monetary policy. The latest national CPI figures show that some of the biggest drivers of inflation are rent, furniture, and insurance premiums. Migration is driving strong demand in the housing sector, with 708,000 overseas students and 380,000 permanent skilled visa holders entering Australia over the past 12 months to August. The insurance industry has had catastrophe claims over the last five years, 75% higher than the preceding five years. In conjunction with general inflation also driving up claims cost, the insurance industry responded with systematic price increases and flagged double-digit premium growth in the just concluded financial reporting season. Since the last national CPI figures for June, oil prices have steadily risen and will add to inflation pressure. Lastly, while wages are more sensitive to monetary policy in that an engineered recession would dampen labour demand, the Australian budget windfall (the big surpluses) is symptomatic of an economy benefitting from reasonable global macroeconomic conditions that support our key exporters. Stating all this in another way, the RBA raising interest rates will not cause less migration, dissuade the insurance industry from recouping its losses, make oil prices go down or cause China to buy less iron ore. The question for us is whether the RBA will dogmatically target inflation with higher rates or pursue a more nuanced approach. Fuelling the discussion is the need for more clarity around the mindset of the new RBA governor or the new governance structure to shape future policy decisions. Generally, rising rates would be bad for equity markets, while a pause/cut would be good for markets. We sit on the fence regarding the Australian equity market until the new look RBA has had an opportunity to season.

Lastly, observing macroeconomic conditions locally and abroad, besides selected parts of Europe, a recession in Australia or the US within the next six months seems very unlikely. Generally, strong employment and better-than-expected consumption supported by covid-era stimulus have kept macroeconomic conditions buoyant despite the sharp increases in central bank policy rates. However, the risk of slowing further afield keeps us cautious on risk assets. China's reforms that have targeted its property sector have led to a broad slowing in the economy. A turnaround in China's economy (and equity markets) likely needs broad fiscal stimulus the government has been unwilling to administer (policy support announced so far has been very targeted). However, the persistent underperformance of China's equity market has extended to where we now believe the balance of outcomes justifies removing our underweight call to Emerging Markets.

Sticky inflation also means it is unlikely that Central Banks will move to end their tightening stance, which should keep the general interest rate environment flat with the potential for higher interest rates in the near term. This environment has historically been challenging for interest rate-sensitive equities.

* https://apolloacademy.com/31-percent-of-all-us-government-debt-outstanding-matures-within-12-months/

Outlook and Positioning

Growth Assets	Underweight			Neutral			Overweight
Australian Equities				●			
Large Caps				●			
Small Caps				●			
Developed Market Equities			●				
Small Caps				●			
Emerging Market Equities				●			
Australian Listed Property				●			
Global Listed Property				●			
Global Listed Infrastructure			●				
Growth Alternatives				●			
Defensive Assets	**Underweight**			**Neutral**			**Overweight**
Australian Bonds					●		
Global Bonds				●			
Diversified Income					●		
Conservative Alternatives				●			
Cash				●			

From here, watch what the new-look RBA does, signs China's economy is stabilising and for continued orderly global macroeconomic deceleration.

Within defensive assets, we are building duration back into portfolios with a preference for Australian long-term government debt. We also Overweight short duration/variable rate, investment grade debt to take advantage of attractive short-term interest rates.

Within growth assets, we remain Underweight global equities but take a more neutral view on China as we believe the risks around China are now more balanced. The general interest rate environment should continue to be influenced by sticky inflation, which is negative for interest rate-sensitive equities. Accordingly, we have moved our Listed infrastructure to Underweight.