Lonsec

Portfolio Perspectives

Insights from the CIO Office

November 2023

Nathan Lim

Chief Investment Officer,

Lonsec Investment Solutions

Lonsec

Key Messages for Investors

- We are at the beginning of the end of this economic cycle. However, the duration of this slowdown remains elusive as employment conditions remain robust. Historical US recessions have been as short as two months to as long as 18 months but have averaged ten months overall. Now is the time to be cautious but not outright bearish.
- Interest rates will stay higher for longer. Short-term interest rates continue to be influenced by inflation that, in turn, is not falling fast enough because of factors outside Central Banks' control. For example, Reserve Bank of Australia (RBA) rate hikes will not mitigate the inflationary impact of strong immigration pushing up rental prices. For long term interest rates, the unsustainability of the US fiscal path remains a simmering issue, putting upward pressure on long-term interest rates.
- Compensation to Equity investors is poor for taking on equity risk at this point in the cycle. Equally poor expected earnings growth compounds the disadvantage to Equity investors.
- We have started to apply hedges in our global equity allocations to reflect the extreme move we have seen in the Australian Dollar.

Lonsec believes we are at the start of the end of this cycle. From here, economic growth will stall, credit quality will deteriorate, corporate profits will fall, and unemployment will rise. However, we are still debating how long this part of the cycle lasts. Looking to the US for guidance and looking at the last 13 recessions since 1945, we know this part of the cycle was as short as two months during the Covid Crisis and could be as long as 18 months during the Global Financial Crisis (GFC), but overall, the average length was ten months. We believe the clock has started as seen in the US Leading Economic Indicators (LEI), which generally precede or coincide with recessions with a sharp fall in the index – a pattern repeated in the last several recessions. Today, the LEI has fallen in a straight line for the previous 18 months to the most recent reading in August. However, to get confirmation that the recession has begun, you need to see unemployment rising – today, employment conditions remain robust. They are so good that some industries are willing to strike to make this point. In fairness, employment conditions have likely peaked as wage growth is slowing, and the number of hours people work is now going backwards.

We are still doing our work and looking to make the first decisive move to reduce risk in portfolios, but we have yet to do so. This is important because reducing growth assets from portfolios too early can be just as damaging as the drawdown you are trying to avoid. Equity markets have an upward bias, and sitting too long in cash presents an opportunity cost. Remember, in Australia, cash is still paying a negative real return (a 4% term deposit does not offset 6% inflation), so it is not yet the time to become bearish, cautious but not bearish.

Interest rates will stay higher for longer. Importantly, we are talking about the entire yield curve - both short and long-term maturities. Remember that Central Bank decisions drive the short end. In the short end, while inflation is slowing, it is not slowing fast enough. Australian and US inflation remains well above the targets set by the Reserve Bank of Australia (RBA) and US Federal Reserve (Fed), respectively. In the absence of a significant deflationary event, it seems very unlikely to us that inflation will settle in the near term. Part of the inflation issue is that factors beyond Central Bank control continue to push prices higher. In last month's CIO Office update, we touched on this point and again reiterate that RBA rate hikes will not mitigate the inflationary impact of strong immigration pushing up rental prices.

Looking at the longer end of the yield curve, we consider the US Treasury Market as the critical rate that drives rates worldwide. The concerns we discussed in last month's CIO Office update remain and appear to be gaining traction, with the US 10-Year Treasury yield recently breaking 5% for the first time in over 16 years. Even the Fed's Chairman recently commented that the path of the US deficit is not sustainable.

In keeping with our cautious stance, when we look at equity markets in general, we have also observed the Equity Risk Premium (ERP) is getting to extreme levels. The ERP is a straightforward concept – since equities are more risky than bonds, equity investors are paid for taking on this extra risk. The extra payment is called the Equity Risk Premium. The formula has two parts: the return for bonds and the return for equities; the difference is the ERP. Using real numbers (when we wrote this piece), the US 10-Year Treasury Bond yield is 4.8%. The S&P 500 earnings yield (the inverse of the forward PE) is 5.5% (inverse of 18.1x). 5.5% minus 4.8% makes the ERP 0.7%. What is alarming is you have to go back to just before the Dot.com crash to see the ERP at such a low level. Said another way, equity investors are getting paid the lowest in nearly 25 years to take on equity risk. The situation is not as severe in Australia, but we are also moving towards pre-GFC levels.
Looking at the fundamentals, on a rolling 12-month forward basis, US earnings growth is only now turning positive, having been negative for much of 2023. In Australia, earnings growth is still -8%. Unsurprising in Australia, the S&P/ASX200 is flat for the year. However, the S&P 500 is up ~10% year to date, which is nearly entirely due to the performance of the Magnificent 7 (Apple, Microsoft, Alphabet, Amazon.com, Nvidia, Tesla and Meta Platforms). The equal-weighted version of the S&P 500 is down ~1% for the year to give you a sense of how narrow the breadth has been. So, while S&P 500 performance has been positive, the backdrop of poor earnings growth and expensive valuations – similar to Australia – is not constructive.

We recently formalised a new foreign exchange policy for Lonsec. We are not looking to trade or make a call on currency in an active manner. Instead, we put this policy together to help manage risk when seeing the Australian Dollar (AUD) at extreme levels. Also, we always hedge our Fixed Income positions, so we are only really focused on our Developed and Emerging Market Equity allocations. The AUD has just reached one of those extremes, and we will start rolling out hedges across our model portfolios. Our approach will be to progressively expand our hedging as market conditions evolve.

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				●			

Growth Assets

Given that valuations are so poor, we are mildly Underweight Developed Market Equities.

We are mildly Underweight Global Listed infrastructure as a higher for longer rate environment will lead to prolonged underperformance for this sector.

Within Growth Alternatives, we strongly prefer multi-strategy Hedge Funds, which have provided low correlation (and thus substantial diversification benefits) with traditional markets.

Defensive Assets

We like Australian Bonds over Global Bonds. As we noted earlier on the fiscal imprudence of the US leading to poor supply/demand dynamics, we have the opposite situation here in Australia. We will likely have another budgetary surplus this year, meaning the supply of new government bonds is shrinking. This relative dynamic is already evident as the yield on the Australian 10-Year Bond is below the US equivalent, a rare historical event.

Reflecting our cautious but not bearish stance on markets, we believe Diversified Income (code for short duration, variable rate securities) is a good source of absolute returns.

Within Defensive Alternatives, we keep an allocation to gold as a diversifier during these troubling times.