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Insights from the CIO Office

December 2023

Key Messages for Investors

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- Macroeconomic conditions are decelerating, but the impact is not evenly felt .
- The 2-Speed Australian Consumer reflects our assertion that the wealthiest portion of the country is carrying the aggregate economy.
- Even between nations, the relative economic performance is widening.
- The best examples of the haves and have-nots are the S&P500 and the Magnificent 7 (M7). Considering the US market as a whole, it looks very expensive, but when you break out the M7, a very different picture emerges.
- Now is the time to use active managers in your clients' portfolios, abide by the rules of diversification, and speak to your clients to ensure their portfolios align with their financial goals.

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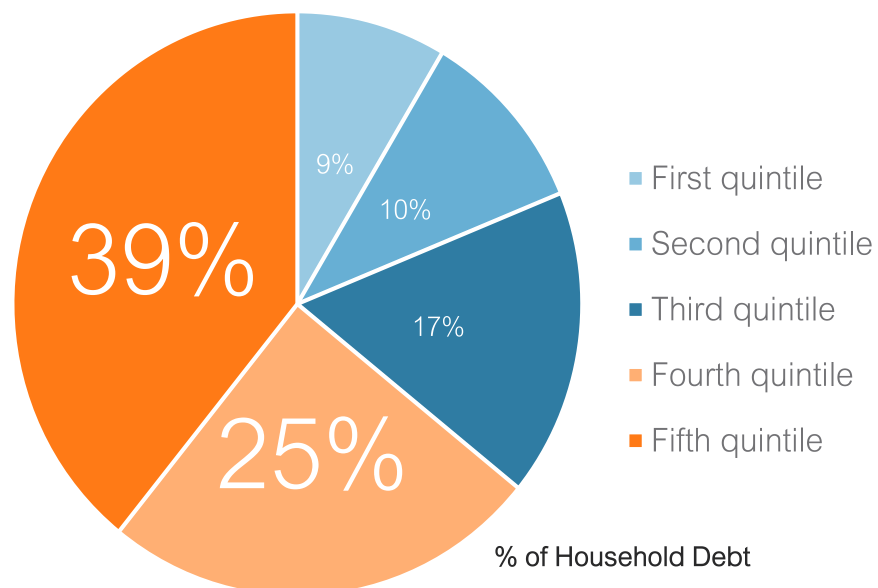
Look beyond the averages

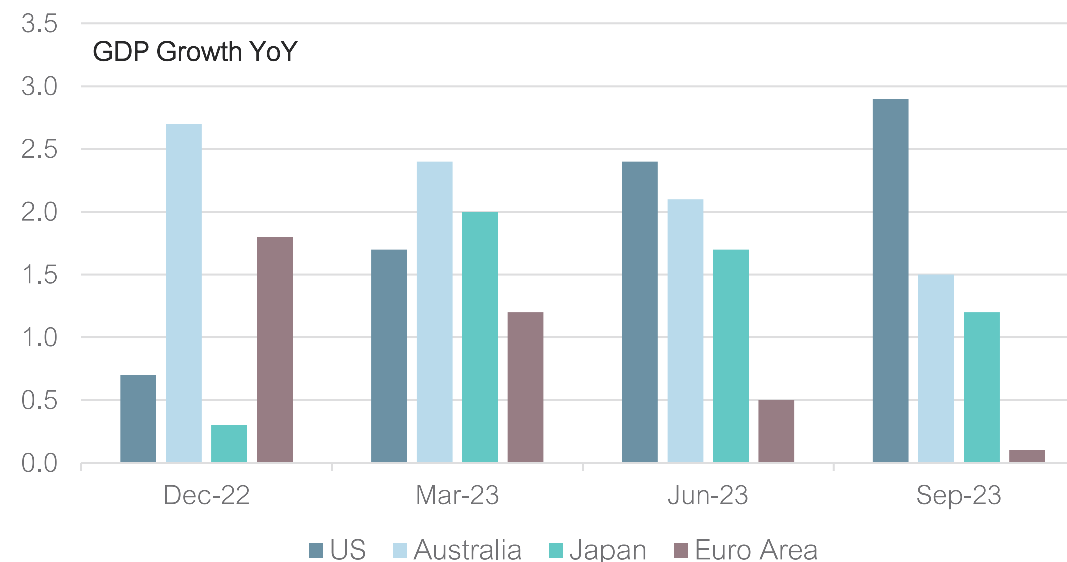
Aggregate data hides diverging trends

Wealthiest 40% (4th+5th Quintile) of Australia holds 64% of household debt



- The wealthiest 40% of the Australian population, hold 64% of the debt and 63% of the gross disposable income. Using the Commonwealth Bank data as a proxy for the financial health of households, credit card arrears are currently 0.55%, flat for the last two years and still well below pre-Covid levels. Similarly, mortgage arrears at 0.47% are near their lowest in the previous ten years. This means our nation's debt is mainly in the hands of those who can afford it, and they are not struggling to pay their debts.

Unsynchronised economic growth in Developed Markets



- Globally, the dynamic between those doing well and those not, is also apparent. Looking at the Developed World (US, Japan and Europe still make up 49% of global GDP), there is a clear de-synchronisation in global growth, with Europe slowing the fastest, followed by Japan. The US on the other hand, is going from strength to strength and is forecast to grow profits by more than 10% next year, the only one in this group at double digits (Europe trails the group at -3%). Australia is also slowing but from a much higher base than our peers.

Notes: Australia's Sep-23 GDP growth is a market consensus estimate. Source: ABS, Bloomberg, Commonwealth Bank, Lonsec estimates.

Diverging economic performance = Divergent valuations

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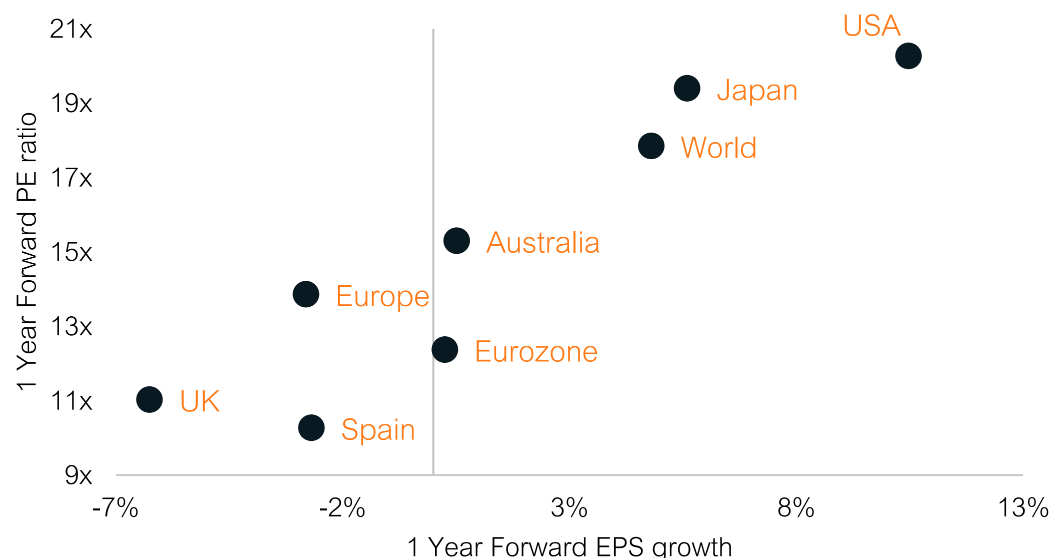
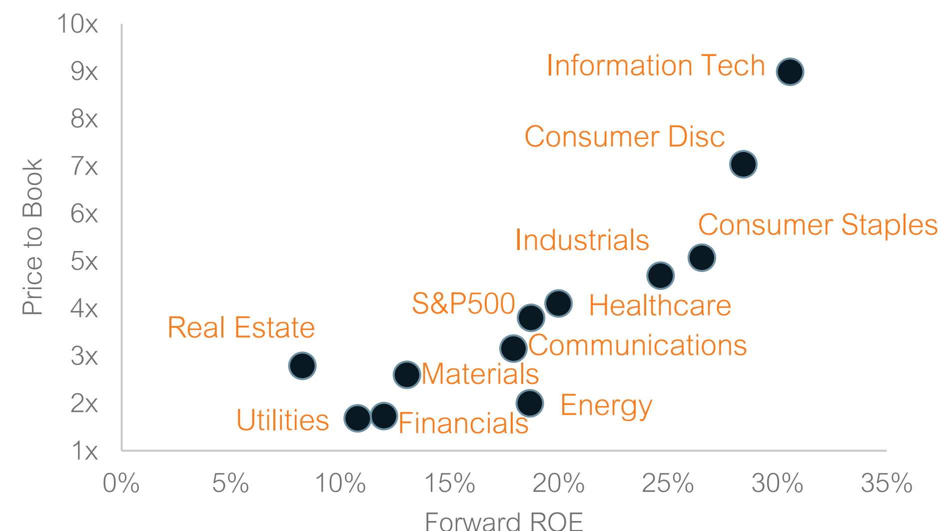
The US sharemarket leads on valuation but also fundamentals. US Technology is the key driver.

Forward Price/Earnings Ratio vs Earnings Per Share Growth



- The difference in expected profits can also explain the valuation discrepancies we see across regions, with Europe on a forward PE of 14x, Australia at 15x, Japan at 19x and the US at 20x.

Price/Book ratio vs 1yr Forward ROE



- Digger deeper into the US, we find the Magnificent 7 and the broader technology sector are driving the market higher on strong fundamentals. The overall Technology sector has a Return on Equity (ROE) 63% higher than the average for the S&P500 (31% versus 19%). Technology companies get significantly more out of their balance sheet than their index peers. Considering the generally low leverage levels amongst Technology companies, that is a remarkable use of shareholder capital, further justifying this group's valuation multiples.

Source: Bloomberg, Lonsec estimates.

Outlook and Positioning

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From here, watch the Australian dollar for further strength after we rolled out hedging in our portfolios; Japanese Government Bonds response to the Bank of Japan winding back Yield Curve Control (YCC); the holiday shopping season for signs of consumer stress (or not); and potential stabilisation in the Chinese property market.

Growth Assets		Underweight		Neutral		Overweight	
Australian Equities				●			
Large Caps				●			
Small Caps				●			
Developed Market (DM) Equities			●				
Small Caps				●			
Emerging Market (EM) 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

- Global equities valuations appear more stretched, particularly in the US, thanks to the stellar outperformance of the Magnificent 7 this year.
- Emerging Market equities valuations look attractive with much of the bad news around China priced in. Risks to the upside should further Chinese stimulus be forthcoming.
- Global Listed Infrastructure. Higher for longer interest rate environment presents a headwind for this sector given the leverage typically associated with these companies. Better risk/return opportunities in defensive assets for investors seeking yield.

Defensive Assets

- Australian Bond yields are now offering good value and bonds can once again play a defensive role in diversified portfolios.
- Global Bonds. Supply/demand imbalances in the US treasury market remain a focus, reducing their relative preference versus Australian government bonds. The expected gradual unwinding of YCC policy in Japan should lead to an extended period of relative underperformance in Japanese Government Bonds.
- Floating rate yields remain higher than fixed rate yields.
- We keep an allocation to gold as a diversifier during these troubling times.

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