Lonsec

Portfolio Perspectives

Insights from the CIO Office

February 2024

Nathan Lim

Chief Investment Officer,

Lonsec Investment Solutions

Key Messages for Investors

- Lonsec moves into the 'soft landing' camp
- The services economy is the key driver within most major economies and this portion of the global economy remains in expansionary conditions
- Consumer spending is constructive, fuelling the services economy
- Unemployment is near multi-decade lows representing a robust position to face any macroeconomic weakness
- Central banks are reducing the risk of a policy mistake by starting to talk about potential interest rate cuts
- Portfolios are being repositioned away from "Risk Control" in favour of "Market Exposure"
- Consider adding Global Small Caps to your portfolio

Alan Blinder, the former vice chairman of the Board of Governors of the US Federal Reserve System, has provided a framework to understand the late cycle. While his recent paper discusses the number of times the US Federal Reserve Board ("The Fed") has achieved a soft landing (six times since 1965), the definitional framework is instructive. Blinder defines a 'soft landing' as a decline in GDP by less than 1%, and the National Bureau of Economic Research (NBER) does not declare a recession. Using this definition, when Lonsec observes the current economic landscape, we are firmly in the 'soft landing' camp.

Services Are The Key

It is worth repeating that the US, Eurozone, Japan and China comprise 61% of global GDP. Within each economy, services (rather than manufacturing) represent the majority of economic activity. The US leads this measure at 78% of GDP, while China is 54%. Accordingly, the direction of the Services portion of the global economy is pivotal for its outlook. A simple average of the Services Purchasing Managers Index (PMI) for this group of four remains above 50, the critical threshold demarking expansionary or contractionary conditions. This measure has only dipped below 50 once since 2021. While the average is only a modest 51, even a soft expansion in the services sector can underpin global growth.

Consumers Keep Spending

With most of the economy still expanding, household spending for this group of four also continues to grow, with retail sales averaging ~4% for much of 2023. Anecdotal comments from retailers and surveys also point to solid Christmas trading, suggesting an acceleration from the average into the end of the year. Consumer spending is fuelling the services economy, which is a cause for optimism.

Employment Remains Solid, Mostly

Unemployment in this group of four continues to be at multi-decade lows, meaning labour markets remain tight. Said another way, it will take an extended period of job losses to bring labour markets to even concerning levels. More importantly, the Services PMI provides additional comfort because its employment sub-index in three groups remains above 50. However, the US was a notable exception, with the reading falling over 7 points in December to 43.3. To put the deterioration in the US into context, to get the US unemployment rate back to the long-term average of 5.7%, the US needs to add 3.2 million unemployed persons, all else equal. The US has added 2.4 million employed persons on average since 2009, excluding the Covid recession.

This combination of modest growth in the services economy, modest ongoing household spending, and a starting point of robust employment all point to a soft, but not disastrous, economic outlook.

Looking at Australia, the services sector constitutes 66% of the economy, and while the Services PMI has dipped below 50, the employment sub-index remains comfortably over 50, where it has been through 2023. Retail sales averaged 3.6% for much of 2023, and comments from retailers were positive for December. Lastly, the unemployment rate remains near its all-time low (we have records that only go back to 1978!). Additionally, a significant stimulus package will hit the economy through Stage 3 tax cuts, estimated to unleash nearly $15 billion of incremental spending from Australian households starting from July 1. This is equivalent to 0.6% of GDP. However, this is only first-order impacts and does not include multiplier impacts as the stimulus finds its way into the broader economy. With little respite from inflation pressures to date, this potential surge in spending could result in the Reserve Bank of Australia (RBA) needing to raise interest rates again in 2024. While our base case is for the RBA to remain on hold over the course of 2024, the upside risk to inflation is something we are watching keenly.

Outlook and Positioning

Our previous Portfolio Perspective describes our positioning as cautious but not bearish. A soft landing is decidedly more optimistic at this point of the cycle, and we are reflecting this in our portfolios. As a result, we have started to decrease our portfolios' "Risk Control" elements and increase our "Market Exposure". We agree with the market that central banks are likely to ease their monetary policies, but not at the rates currently shown by market pricing. Persistent inflation will temper central bank actions.

After reviewing our Dynamic Asset Allocation (DAA), we have decided to move from being slightly Underweight Global Equities to Neutral. We prefer investing in Global Small Caps over Global Large Caps based on the relative valuation opportunity we are seeing. Diversified Fixed Income will fund the move back to Neutral. Unless there is any unexpected inflation surprise, policy rates have probably peaked in most developed markets. Longer-duration fixed income offers better value.

Lastly, we want to acknowledge that unlike the US, Europe's current economic position is challenged and we remain cautious about investing in this region.

On the horizon, keep an eye on the Australian dollar as it has recently weakened again, observe any policy changes from the Chinese government to inject more meaningful stimulus into its economy, a change in the scope and magnitude of fighting in the Ukraine and Israel, and developments in the US presidential primaries.

Growth Assets	Underweight			Neutral		Overweight	
Australian Equities				● Current			
Large Caps				● Current			
Small Caps				● Current			
Developed Market Equities			● Current	● New			
Large Caps			● Current				
Small Caps				● Current	● New		
Emerging Market Equities				● Current			
Australian Listed Property				● Current			
Global Listed Property				● Current			
Global Listed Infrastructure			● Current				
Growth Alternatives				● Current			

Defensive Assets	Underweight			Neutral		Overweight	
Australian Bonds					● Current		
Global Bonds				● Current			
Diversified Income				● New	● Current		
Conservative Alternatives				● Current			
Cash				● Current			

Current Position ●
New Position ●

Growth Assets

Asset Class	Position	Rationale
Australian Equities	Neutral	The outlook for Australian equities remains positive driven by strong commodity prices, population growth and a resilient consumer. Market valuation appears 'fair' with ongoing strength in iron ore prices and the potential for rate cuts over FY25 providing a positive backdrop for earnings growth over the year.
Developed Market Equities	Neutral	Global equity valuations appear more stretched, particularly in the US, thanks to the stellar outperformance of the Magnificent 7 this year. This robust performance has resulted in a dispersion in valuation between Small/Mid-Caps and Large Caps, with small/mid-caps looking attractively priced.
Emerging Market Equities	Neutral	While valuations look attractive on a relative bases, emerging market currently look to be fairly priced, with main valuation metrics sitting in line with their long-term average. But with so much uncertainty around China and its growth outlook, risk look to be slightly elevated.
Australian Listed Property	Neutral	Valuations are attractive enough to maintain a neutral position and the risk of further interest rate hikes has decreased. Highly nuanced depending on sub-sector, with the office sector in particularly remaining structurally challenged.
Global Listed Property	Neutral	Valuations are attractive enough to maintain a neutral position and the risk of further interest rate hikes has decreased. Highly nuanced depending on sub-sector, with the office sector in particularly remaining structurally challenged.
Global Listed Infrastructure	Slight Underweight	Better risk/return opportunities in defensive assets for investors seeking yield, and better growth opportunities in equities. Uncertainty over the path of inflation and rates presents a headwind for this sector, given the leverage typically associated with these companies.
Growth Alternatives	Neutral	Prefer liquid multi-strategy hedge funds over private market exposures where prices remain elevated. We maintain FX hedges within our global exposures as the AUD continues to trade at levels we consider cheap.

Defensive Assets

Asset Class	Position	Rationale
Australian Bonds	Slight Overweight	Bond yields are now offering good value and bonds can once again play a defensive role in diversified portfolios.
Global Bonds	Neutral	Supply/demand imbalances in the US and the likely end of yield curve control policy in Japan may see yields move higher offshore
Diversified Income	Neutral	Floating rate yields remain higher than fixed rate yields however we have slightly trimmed the position given the potential for rates cuts later this year.
Conservative Alternatives	Neutral	Gold acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.
Cash	Neutral	Provides short term liquidity with a modest yield.

Important Notice: This document is published by Lonsec Investment Solutions Pty Ltd (LIS) ACN: 608 837 583, a corporate authorised representative (CAR number: 1236821) of Lonsec Research Pty Ltd ABN: 11 151 658 561 AFSL: 421 445 (Lonsec Research). LIS and Lonsec Research are owned by Lonsec Holdings Pty Ltd ACN: 151 235 406. LIS creates the model portfolios it distributes using the investment research provided by Lonsec Research but has not had any involvement in the investment research process for Lonsec Research. Please read the following before making any investment decision about any financial product mentioned in this document.
Disclosure at the date of publication: Lonsec Research receives a fee from the relevant fund managers or product issuers for researching financial products (using objective criteria) which may be referred to in this document. Lonsec Research may also receive a fee from the fund manager or product issuer (s) for subscribing to research content and other Lonsec Research services. LIS receives fees for providing investment consulting advice, approved product lists, model portfolios to financial services professionals and other advice to clients. LIS' and Lonsec Research's fees are not linked to the financial product rating(s) outcome or the inclusion of the financial product(s) in model portfolios. LIS, Lonsec Research and/or their associates may hold any financial product(s) referred to in this document, but details of these holdings are not known to the analyst(s).
Warnings: Past performance is not a reliable indicator of future performance. Any express or implied rating or advice presented in this document is limited to "general advice" (as defined in the Corporations Act 2001 (Cth)) and based solely on consideration of the investment merits of the financial product(s) alone, without taking into account the investment objectives, financial situation and particular needs ("financial circumstances") of any particular person. Before making an investment decision based on the rating or advice, the reader must consider whether it is personally appropriate in light of their financial circumstances or should seek independent financial advice on its appropriateness. If the advice relates to the acquisition or possible acquisition of a particular financial product, the reader should obtain and consider the Investment Statement or the Product Disclosure Statement for each financial product before making any decision about whether to acquire the financial product.
Disclaimer: LIS provides this document for the exclusive use of its clients. It is not intended for use by a retail client or a member of the public and should not be used or relied upon by any other person. No representation, warranty or undertaking is given or made in relation to the accuracy or completeness of the information presented in this document, which is drawn from public information not verified by LIS. Financial conclusions, ratings and advice are given on reasonable grounds held at the time of completion (refer to the date of this document) but subject to change without notice. LIS assumes no obligation to update this document following publication. Except for any liability which cannot be excluded, LIS and Lonsec, their directors, officers, employees and agents disclaim all liability for any error or inaccuracy in, misstatement or omission from, this document or any loss or damage suffered by the reader or any other person as a consequence of relying upon it.
This report is subject to copyright of LIS. Except for the temporary copy held in a computer's cache and a single permanent copy for your personal reference or other than as permitted under the Copyright Act 1968 (Cth), no part of this report may, in any form or by any means (electronic, mechanical, micro-copying, photocopying, recording or otherwise), be reproduced, stored or transmitted without the prior written permission of LIS.
This document may also contain third party supplied material that is subject to copyright. Any such material is the intellectual property of that third party or its content providers. The same restrictions applying above to LIS copyrighted material, applies to such third-party content.
Copyright © 2024 Lonsec Investment Solutions Pty Ltd