Portfolio Perspectives

Insights from the CIO Office

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Key Messages for Investors

- We remain late cycle but believe a “soft landing” is still plausible
- The services sector, not manufacturing, has a more significant impact on the global economy
- As long as the Services Purchasing Managers Index across the US, Eurozone, Japan and China remain above 50, a “hard landing” is unlikely
- Retail spending continues to support the services sector because employment conditions remain strong
- Inflation remains sticky and Central Bank interest rate cuts may take longer than the market expects
- There is a risk that the Reserve Bank of Australia will have to raise interest rates
- Consider adding Global Small Caps to your portfolio

As investors, it's crucial to periodically review our current positioning and evaluate whether any changes are necessary. Several months ago, the US Leading Economic Indicators (LEI) signalled that the US economy had reached the end of its current economic cycle. In almost all previous recessions in the US, there has been a sharp decline in the LEI before the recession. The indicator has now recorded its 19th consecutive month of year-over-year decreases, which strongly indicates an upcoming recession. However, Lonsec's view that we might experience a "soft landing" is, we think, still plausible. The Conference Board publishes the LEI and has recently withdrawn its warning for a US recession, instead predicting only muted growth for 2024.

Focus on the Services Sector

Investors should remember that the services sector, not manufacturing, has a more significant impact on the global economy. Even China, known as the world's factory, generates around 54% of its GDP from the services industry. The average of the Services Purchasing Managers Index (Services PMI) across the US, Eurozone, Japan and China is consistently above 50, the critical level separating an assessment of either expanding or contracting economic activity. We believe that as long as the services component of the economy remains in expansionary territory, the possibility of a "hard economic" landing is unlikely.

Retail Sales Fuelling the Services Sector

The Services sector requires fuel to sustain growth, and retail sales are the best indicator of this driver. During the crucial Christmas shopping period, the average retail sales for the four major economies remained inline with the ~4% average growth achieved earlier in 2023. However, we suspect that national statistics may be masking what we describe as the "two-speed consumer" phenomenon. For instance, in Australia, the Australian Bureau of Statistics (ABS) has previously noted that income and wealth tend to increase over one's lifetime, peak before retirement, and then decline as people stop working and start to draw on sources of wealth like superannuation. This uneven distribution of wealth was evident in the latest financial results of the Commonwealth Bank, which described spending and savings among its customers segmented by age. In the December 2023 quarter, the bank's older customers (over 45) continued to increase discretionary spending and savings despite the nation's widely publicized cost of living crisis. When discretionary spending is rising among the wealthier population but declining between 1% to 1.5% for those below the age of 34, it serves as a reminder that the driver of economic growth is disproportionately falling on affluent households.

Employment Supports Spending

The general public appears confident enough to continue spending. This could be attributed to the low levels of unemployment, which have been reported in many countries, including some all-time lows. However, it remains to be seen whether these favourable employment conditions will persist.

Although some corporations seem hesitant to hire new employees, the average Services PMI employment subcomponent reading in the four major regions has risen above 50 in January, indicating a rebound after a brief dip in December. Even Europe, which narrowly avoided a recession, and Japan, which entered a technical recession, have shown improved employment conditions at the start of this year.

The strong employment conditions have fueled the Services sector, which has kept the global economy ticking over, albeit at modest levels. In Australia, unemployment remains near all-time lows, the Services Employment Index increased in the past two months, and retail spending in December, despite being soft, remained positive overall. Wealthier households continue to spend, which supports a muted outlook for Australia but with an upside risk to growth.

Inflation Remains Sticky

Lonsec maintains its view that inflation will remain stubbornly high. Although inflation data from all regions shows a reduction, it is slower than the market expected. In Australia, inflation also remains high, and the Stage 3 tax cuts could worsen the situation by increasing inflation and potentially causing an upside risk for the economy. Lonsec previously estimated that the tax cuts are equivalent to 0.6% of GDP. However, this is only a first-order impact and does not include multiplier effects as the stimulus spreads throughout the broader economy.

Additionally, with wage growth still above 4% (well above the Reserve Bank of Australia's (RBA) target inflation range of 2-3%), the high level of inflation could become entrenched. With little relief from inflationary pressures so far, this potential surge in spending could lead to the RBA needing to raise interest rates again in 2024. While our base case is for the RBA to remain on hold throughout 2024, we closely monitor the upside risk to inflation.

Outlook and Positioning

We continue to hold our optimistic view on the economic cycle, supported by positive macroeconomic data and sentiment. We anticipate that central banks will loosen their monetary policies, but at a slower rate than currently predicted by the market. It's worth noting that the market has recently adjusted its expectations for future rate cuts in line with our position, as persistent inflation will likely moderate central bank actions.

Our Dynamic Asset Allocation (DAA) remains unchanged this month, with a broadly neutral stance across asset classes. We prefer investing in Global Small Caps over Global Large Caps in the Global Equities category, given the relative valuation opportunity that we see. Regarding defensive investments, we see value in holding longer-duration fixed income as it provides some protection if we are wrong and macroeconomic conditions worsen.

Looking ahead, we recommend keeping an eye on the weakness of the Australian dollar, monitoring any policy changes from the Chinese government to stimulate its economy meaningfully, observing any changes in the scope and magnitude of fighting in Ukraine and Israel, and tracking developments in the US presidential primaries.

A Special Comment on Lonsec's Gold Allocation

Central banks are buying gold to strengthen their currencies and reduce reliance on the US dollar. According to the latest data from the World Gold Council, central banks have purchased over 1,000 tonnes of gold each year for the past two years. In 2023, the People's Bank of China acquired 225 tonnes, bringing their total gold holdings to 2,235 tonnes, or about 4% of their international reserves.

Gold offers several advantages for investors looking to diversify their portfolios and manage risk. Historically, it has acted as a hedge against inflation and currency devaluation, preserving wealth during economic uncertainty. Additionally, its value tends to increase when traditional assets like stocks and bonds face challenges, making it an effective diversifier that can help lower portfolio volatility and improve risk-adjusted returns.

Given the current uncertain economic and geopolitical environment and the growing interest in gold-backed currencies, demand for gold is expected to remain strong. An allocation to gold within the Lonsec models can be a risk-off diversifier. This helps mitigate downside volatility and improve overall portfolio performance across various market conditions.

Growth Assets		Underweight		Neutral		Overweight	
Australian Equities				●			
Large Caps				●			
Small Caps				●			
Developed Market Equities				●			
Large Caps			●				
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				●			

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.