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Insights from the CIO Office

July 2024

Key Messages for Investors

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- Global macroeconomic forecasts and contemporaneous forward-looking macroeconomic data suggest a positive but muted economic outlook.
- This has prompted the decision to add risk back into the portfolio and reposition for growth.
- Bringing the Growth/Defensive allocation back to Neutral by increasing the allocation in Developed Market Equities and reducing Cash.
- Prefer Europe, Japan and US Small Caps.
- Don’t ignore your defensive battlements and keep your allocations to Defensive assets given risks remain high.
- Inflation is falling but Australia is a worry.
- Equity markets can go higher without interest rate cuts.

Macroeconomic forecasts have improved

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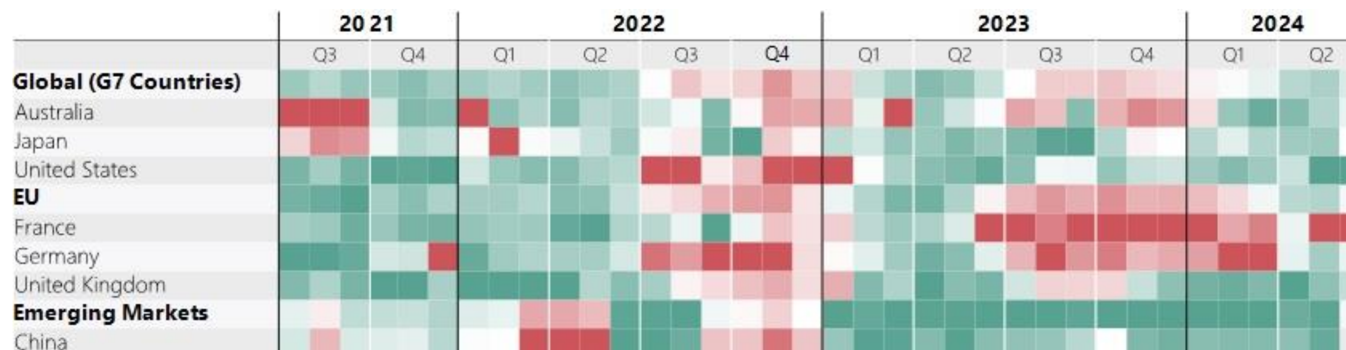
Forecasts point to a muted but positive outlook

- Most country-level consensus forecasts predict a resumption of economic growth in the second half of the year and into next year
- Consensus GDP forecasts for the G7 remain essentially flat for 2025 and 2026.
- Growth in the Asia Pacific is expected to slow from 4.1% in 2024 to 3.8% in 2026.
- Europe is anticipated to accelerate out of its recessionary-like conditions.
- Latin America is also on a path of accelerating growth.
- Contemporaneous, forward-looking macroeconomic data within our Dynamic Asset Allocation cyclical model, across regions and indicators confirming the general positivity in the outlook.
- Notably, Services and Manufacturing PMIs continue to improve, most notably in Europe, but also in the US and in broader measures such as the JP Morgan Global PMI.

Consensus GDP Estimates (% Change)

	2024	2025	2026
G7	1.6	1.6	1.7
Asia Pacific	4.1	3.9	3.8
Europe	1.2	1.7	1.6
Latin America	1.4	2.1	1.8

Our Heat Map is "Greening"



Green = values are above 50; Red = value below 50. A reading above 50 indicates an expansion of the economy in comparison to the previous month and below 50 represents a contraction, while 50 corresponds to no change.

Source: Factset, Macrobond, Lonsec estimates.

Be Nuanced with Developed Market (DM) Equities

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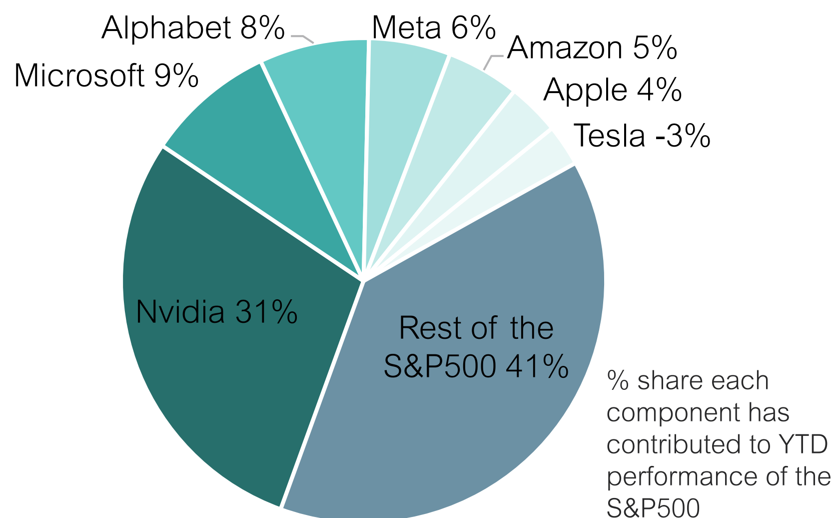
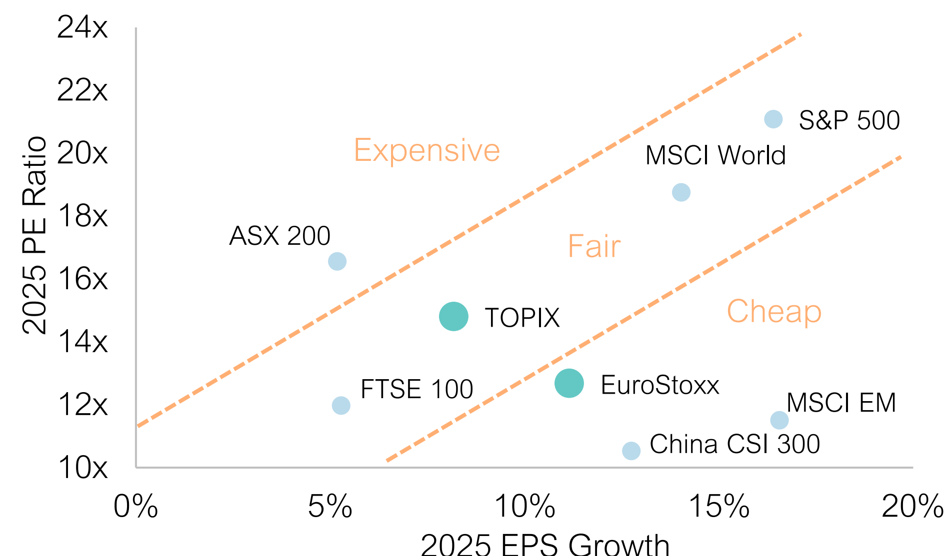
The Magnificent 7 has distorted the US market. Consider Europe and Japan instead

Magnificent 7 accounts for 59% of the S&P500’s ~15% rise year to date (YTD)



PE Ratio vs EPS Growth



- "Magnificent Seven", which refers to the seven largest technology companies listed in the US. These companies, including Apple, Microsoft, and Amazon, have significantly skewed the market's performance.
- We are cautious about adding weight to the US at current levels due to their high valuations, predicated on the perfect delivery of ambitious growth estimates.

- There is a strong linear relationship between prices for stocks and expected profit growth.
- Europe looks cheap given the forecasted profit growth.
- Japan's valuation also looks attractive compared to other developed markets, particularly considering that 2024 and 2025 earnings forecasts are rising. This makes the year-over-year earnings growth optically less appealing, but one must maintain sight of the underlying lift to aggregate profits.

Source: Bloomberg, Lonsec estimates.

The Case for Europe and Japan

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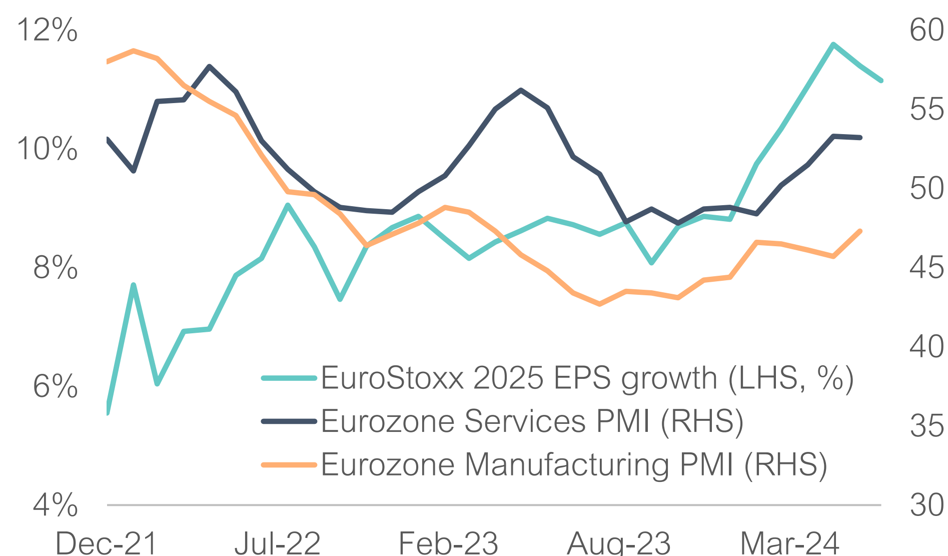
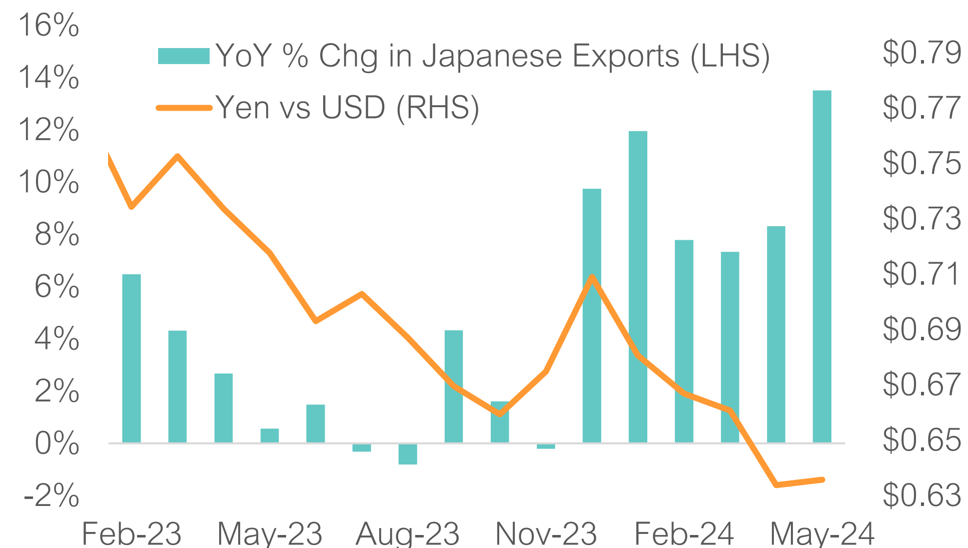
Focus on where corporate profits are growing and can be purchased for reasonable multiples

European corporate profits turning higher as the economy improves



The weak Japanese Yen is driving corporate profits higher



- European corporate profits have upgraded with the improvement in the Manufacturing and Services Purchasing Manager Index.
- The rise of the political Right in Europe is coming at the expense of the Centre. It is too early to be definitive that a shift Right will equate to dramatically different European policy and budgetary settings.
- The high probability of the formation of minority governments equates to a more fragmented political landscape, ensures slower change, and mitigates any economic downside to limiting trade flows.

- Exporters comprise 20% of Japan's economy but 35% of the stock market weight. Their success has helped to drive the Nikkei 225 higher with consensus upgrades to forward earnings expectations.
- With the Bank of Japan signalling little urgency to raise interest rates, we believe the weak Yen and the tailwind for exporters and corporate profits will persist.
- The improvement in corporate governance rolls on and should continue to manifest in better corporate fundamentals and shareholder-friendly buybacks

Source: Bloomberg, Lonsec estimates.

Inflation sticky but slowing. This time it is different for the Fed

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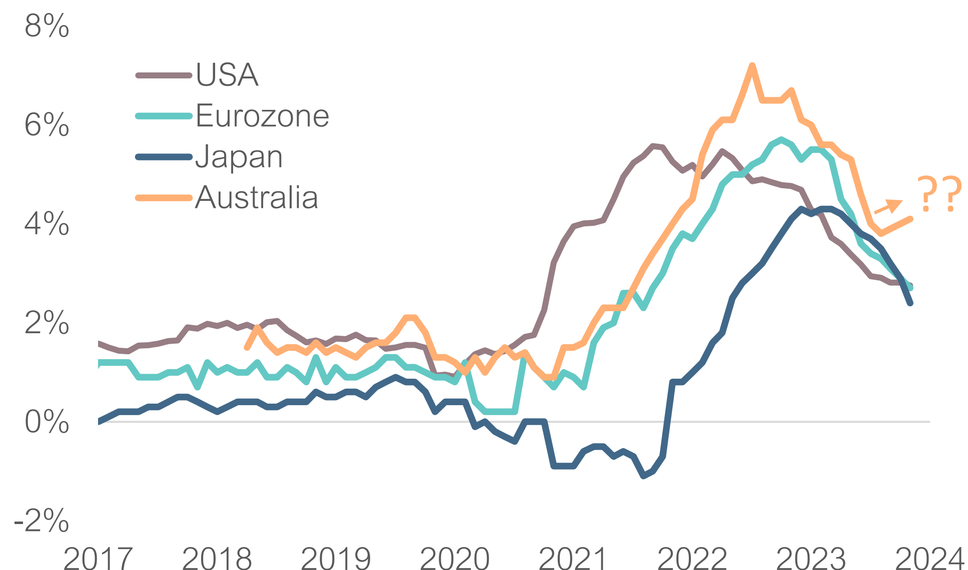
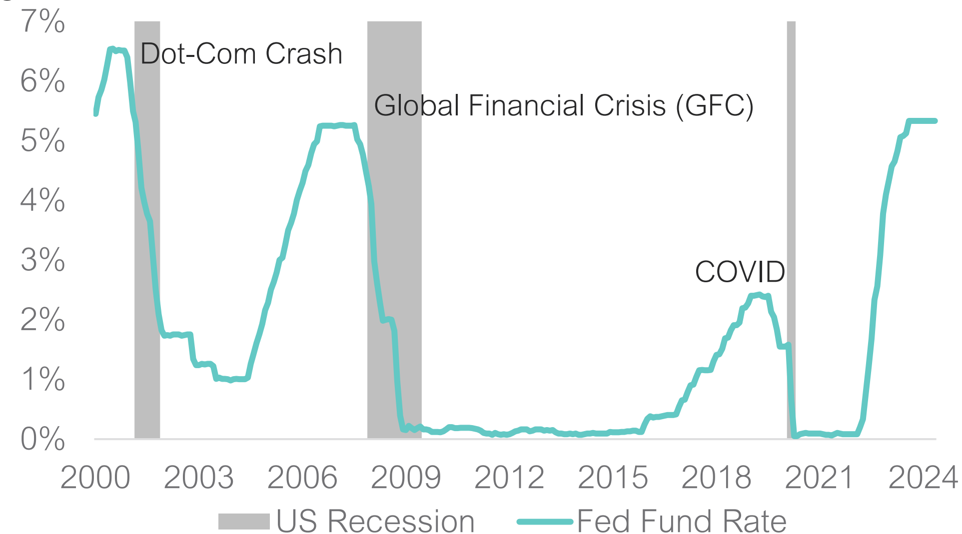
Tight monetary policy is working. The coming Fed easing cycle is starting without a crisis triggering it.

Core Inflation is falling everywhere but Australia is worrying



- Inflation remains sticky, but the direction of travel is down as collective monetary policy settings have tightened fiscal conditions and COVID-era stimulus wanes.
- Australia is the exception, recent figures show inflation still running well above the Reserve Bank of Australia's target band of 2-3%, and the impact of the Stage 3 tax cuts has yet to manifest.

First time in 25 years the US Federal Reserve (Fed) is not cutting into a crisis



- The US Federal Reserve (Fed) will be cutting its interest rates without a crisis. This is the first time in 25 years that the Fed will not be reacting to an exogenous threat or recessionary-like conditions.
- This is an important nuance in this cycle that we believe much of the market has overlooked: we don't need the Fed to be cutting to see the market go higher because the underlying economy and, by extension, corporate profits are enough to lift equity markets higher.

Source: ABS, Bloomberg Lonsec estimates.

Outlook and Positioning

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Becoming constructive on risk. Overweight DM Equities preferring Europe, Japan and US Small Caps. Reducing Cash. Don't ignore your Fixed Income allocations because risks remain.

Growth Assets	Underweight			Neutral	Overweight		
Australian Equities				● Current			
Large Caps				● Current			
Small Caps				● Current			
Developed Market (DM) Equities				● Current	● New		
Large Caps			● Current	● New			
Small Caps					● Current		
Emerging Market (EM) 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				● Current			
Conservative Alternatives				● Current			
Cash			● New	● Current			

Current Position ● (white)
New Position ● (orange)

Growth Assets

- DM Equities. We are taking a constructive approach to risk and bringing the overall Growth/Defensive split back to Neutral by overweighting DM Equities funded by a reduction in Cash.
- DM Equities. The distortion caused by the Magnificent 7 in the US has us preferring Europe and Japan given more attractive valuations.
- DM Equities. DM Small Caps typically move ahead of the turn in the economic cycle, and US Small Caps, in particular, could move with the Fed starting its easing cycle. This leads to a Slight Overweight DM Small Caps with a preference for US over ex-US Small Caps.
- Global Listed Infrastructure. We see better risk/return opportunities in other asset classes for those seeking yield or capital appreciation.

Defensive Assets

- Australian Bond yields are now offering good value and bonds can once again play a defensive role in diversified portfolios. Focus on long-duration assets.
- Global Bonds. Supply/demand imbalances in the US treasury market remain a focus, reducing their relative preference versus Australian government bonds. The end of YCC policy in Japan should lead to an extended period of relative underperformance in Japanese Government Bonds.
- The potential start to an easing cycle reduces the relative attractiveness of floating rate yields.
- We maintain an allocation to gold which acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.

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