Lonsec

Portfolio Perspectives

Insights from the CIO Office

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Key Messages for Investors

- 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.

Global macroeconomic forecasts have shifted and now point to a muted but positive economic outlook. Most country-level consensus forecasts predict a resumption of economic growth in the second half of the year and into next year, albeit at varying levels. For example, the consensus GDP forecasts for the G7 remain essentially flat for 2025 and 2026, while 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, and Latin America is also on a path of accelerating growth.

Concurrently, we are observing forward-looking macroeconomic data turning constructive 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.

Based on these global macroeconomic forecasts and the improving forward-looking indicators we are observing, Lonsec believes it is prudent to reposition for growth by adding some risk back into the portfolio. Driving this decision is our confidence in the economic recovery and the potential for increased returns in the future.

Our first tentative step is to bring our overall Growth/Defensive split back to Neutral by increasing our allocation in Developed Market Equities. Our overall global equity allocation is now Slightly Overweight taking into account our previous views on global small caps. This move has been funded by reducing Cash.

Be Nuanced with Developed Market Equities

Within Developed Market Equities, we recognise the distorting impact of the "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.

Alternatively, consider weighting your exposure towards Japan and Europe. Investors can implement this positioning with tactical ETF/security selection or an active manager aligned with this positioning.

The Case for Europe

European corporate profits have upgraded with the improvement in the Purchasing Manager Index reading in both the manufacturing and services sectors. While the pricing for European equities is only in line

with its long-term average, it looks cheap relative to other Developed Markets.

The rise of the political Right in Europe is coming at the expense of the Centre. Lonsec believes the shift towards the Right is consistent with the global trend towards more populist politics on the back of rising inequalities which has led to increasingly inward-looking policies, protectionism and more pronounced strategic choices. It is too early to be definitive that a shift Right will equate to dramatically different European policy and budgetary settings. This is because of the high probability of the formation of minority governments, which is where the polls suggest France will land, for example. A more fragmented political landscape ensures slower change and mitigates any economic downside to limiting trade flows. For now, we continue to focus on Europe's earnings outlook, which remains sound and available on attractive relative multiples.

The Case for Japan

The weak Yen has been a boon for exporters, who 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.

Like Europe, Japan's valuation 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. 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. Lastly, the improvement in corporate governance rolls on and should continue to manifest in better corporate fundamentals and shareholder-friendly buybacks.

Why didn't we reduce Fixed Income allocations?

With developed market Central Banks broadly poised at the beginning of a rate-cutting cycle, this should create a tailwind for long-duration assets as investors should benefit from capital appreciation on top of their regular income payments. 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 likely to be the exception. Its most 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.

While the consensus is broadly positive and contemporaneous macroeconomic data is supportive, we acknowledge that there are many potential paths the global economy could take, making risks to our base case expectations higher than usual. For example:

- We have yet to test the potential inflationary impact of the Stage 3 tax cuts on Australia, which could push the Reserve Bank of Australia to raise interest rates,
- Numerous ongoing military flashpoints, while finely balanced today, could pivot in unexpected ways (what if Israel enters Lebanon?), and
- While household consumption remains supportive of the Services sector, cost of living pressures are hardily abating, so can the older, more affluent segment of the two-spend consumer continue to carry the economy?

With these risks in mind, we keep our Fixed Income allocations unchanged to preserve the defensive battlements in our portfolio. Our preference for Australian Bonds over Global Bonds is also unchanged, given our expectation that a preference for more fiscally prudent economies will manifest in time (see Portfolio Perspectives, October 2023). Regarding our Diversified Income allocation, given the absolute level of rates and no signs of distress amongst corporate borrowers, the incremental yield pick-up over cash and its associated risk is balanced, suggesting Cash by default is our least preferred asset class to fund a pivot in the portfolio towards Growth Assets.

Outlook and Positioning

We are taking a tentative but constructive approach to risk in our portfolios. Forward-looking macroeconomic indicators and consensus forecasts have improved toward at least a modest macroeconomic outlook. In addition, developed market central banks have begun their rate-cutting cycles which creates a tailwind for markets, although the pace of cuts will not be uniform.

Our Dynamic Asset Allocation (DAA) sees us moving to neutralise our slight Underweight in Growth assets by increasing our allocation to Developed Market equities and reducing our allocation to Cash.

Within Developed Market equities, we prefer Japan and Europe over the US on valuation grounds and the belief that European political change will not manifest in material economic policy changes in the near term. Looking at Developed Market equities through a size lens, we continue to prefer Small Caps over Large Caps as global growth resumes, but we see the best value in US Small Caps over other regions.

It is also worth noting that the long-awaited cutting by the US Federal Reserve (Fed) will occur 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. The Fed is reducing interest rates only to normalise their policy setting.

Looking ahead, watch for the impact of the Stage 3 tax cuts on Australian consumption. The underperformance of Australian Equities versus overseas markets is becoming pronounced and may persist. The conflict in Israel is pivoting north, and investors should prepare for a careful review of any further escalation that leads to a more significant conflict with Hezbollah.

Growth Assets	Underweight			Neutral	Overweight		
Australian Equities				Current			
Large Caps				Current			
Small Caps				Current			
Developed Market Equities				Current	New		
Large Caps			Current	New			
Small Caps					Current		
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				Current			
Conservative Alternatives				Current			
Cash			New	Current			

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

Growth Assets

Asset Class	Position	Rationale
Australian Equities	Neutral	Australian equity valuations look stretched and require a re-rating in bank and resource earnings which does not seem forthcoming. Population growth and a resilient consumer continues to support the economy but inflation looks to be more than just sticky.
Developed Market Equities	Slight Overweight	The robust performance of the Magnificent 7 has resulted in a dispersion in valuation between Small/Mid-Caps and Large Caps, with small/mid-caps looking attractively priced. Geographically, a meaningful valuation gap has open between the US and other developed markets with Japan and Europe exhibiting more sensible prices for reasonable earnings growth.
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, risks 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	Investors can find better risk/return opportunities in defensive assets for investors seeking yield, and better growth opportunities in equities.
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 end of yield curve control policy in Japan may see yields move higher offshore.
Diversified Income	Neutral	We are balanced towards our preference between floating and fixed rate yields given current cyclical dynamics at play
Conservative Alternatives	Neutral	Gold acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.
Cash	Slight Underweight	With cycle risks declining, we believe cash can be put to work in riskier asset classes.

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