



Portfolio Perspectives

Insights from the CIO Office

March 2024

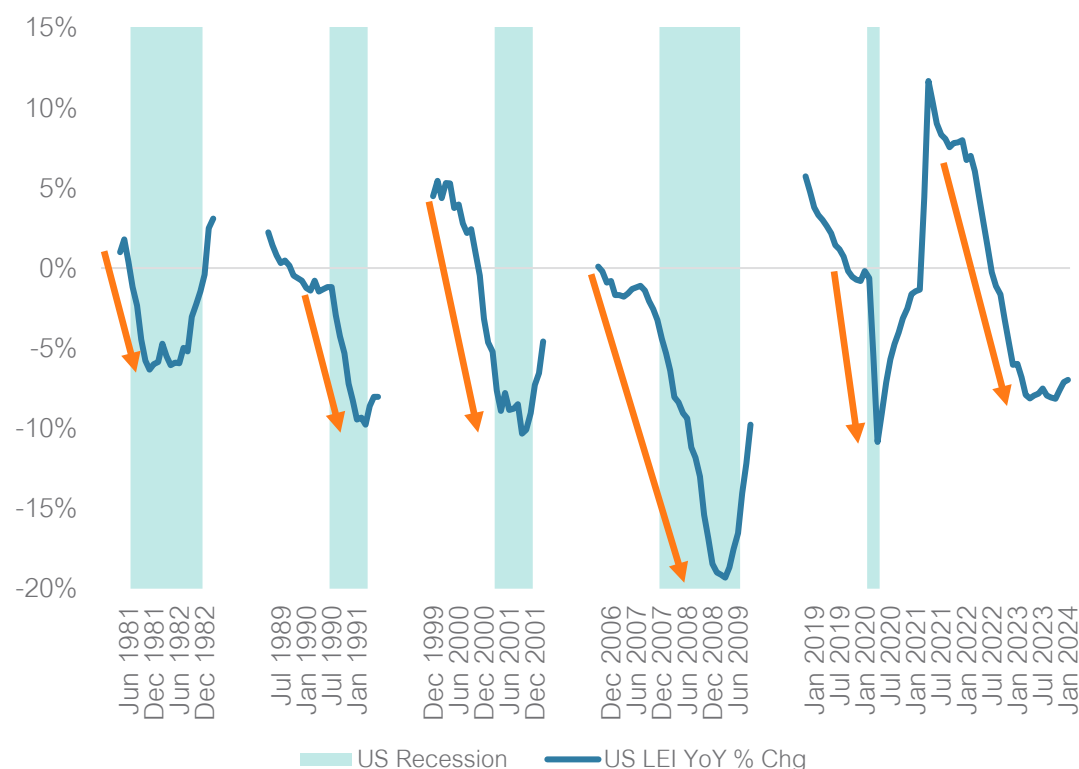
Key Messages for Investors

- 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

We are late cycle but a “soft landing” remains plausible

The US Leading Economic Indicators (LEI) typically fall sharply before or at the beginning of recessions

The LEI has fallen sharply for the last 19 months



- 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.
- The Conference Board publishes the LEI and has recently withdrawn its warning for a US recession, instead predicting only muted growth for 2024.
- This is consistent with Lonsec’s view that a “soft landing” remains plausible.

Source: FRED, NBER Lonsec estimates.

Focus on the Services portion of the economy

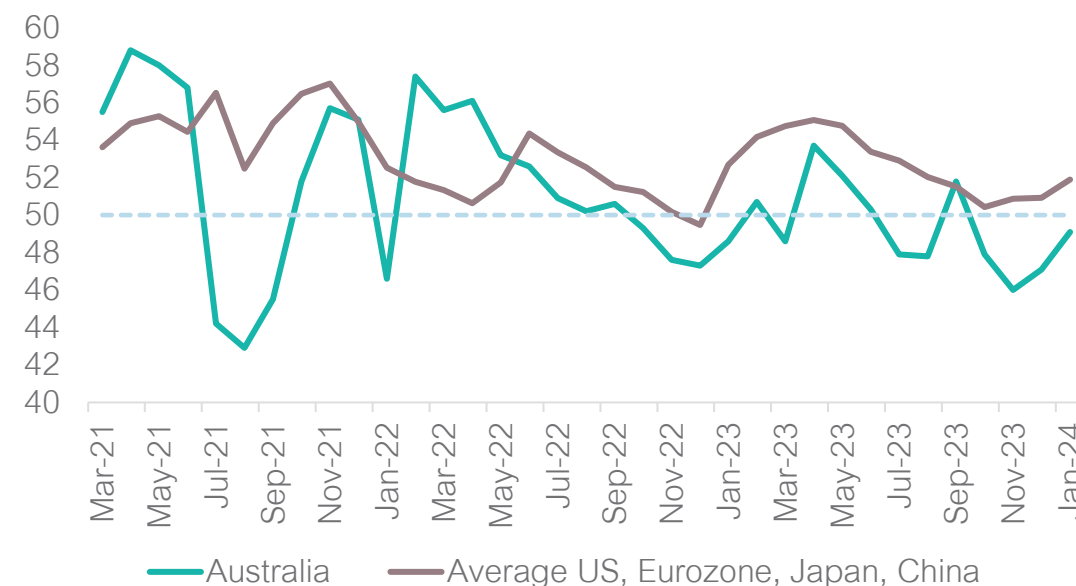
Services are the driver of the economy, not manufacturing

Services Economy % of Gross Domestic Product (GDP)

| | % |
|-----------|------|
| US | 77.6 |
| Eurozone | 65.7 |
| Japan | 69.9 |
| China | 53.5 |
| Average | 66.7 |
| Australia | 65.7 |

- Services represent the majority of economic activity in significant economies
- 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%.

Services Purchasing Managers Index (PMI)

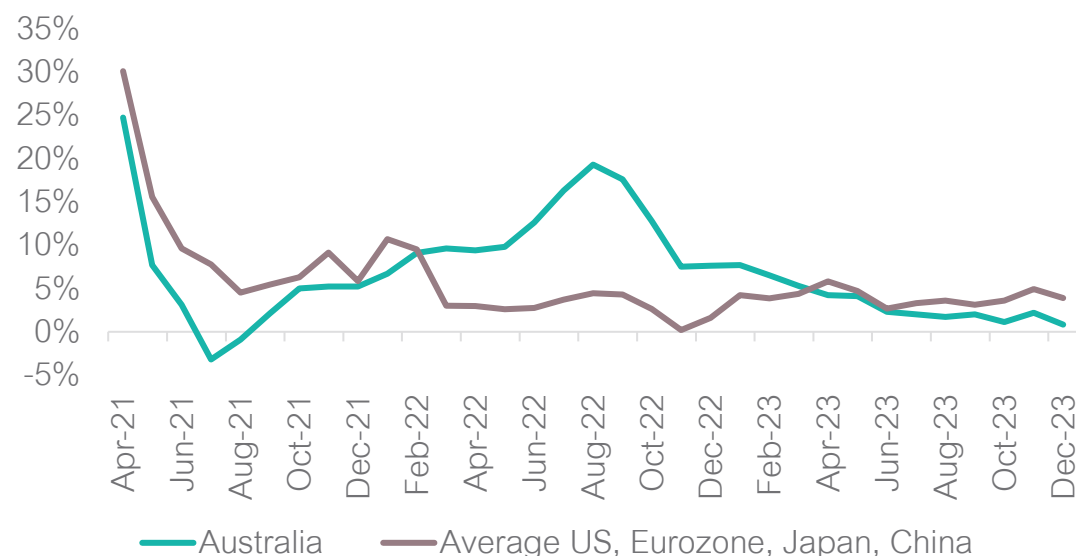


- The average of the Services Purchasing Managers Index (Services PMI) across the US, Eurozone, Japan and China is consistently above 50, the critical level separating an assessment of either expanding or contracting economic activity.
- We believe that as long as the services component of the economy remains in expansionary territory, the possibility of a "hard economic" landing is unlikely.

Household spending supported by record unemployment

Households are still spending and employment starting from a position of strength

Retail sales growth Year-over-Year



- During the crucial Christmas shopping period, the average retail sales for the four major areas (department stores, convenience stores, supermarkets and specialty stores) remained inline with the ~4% average growth achieved earlier in 2023.

Unemployment Rates – December 2023 (%)

| | % |
|-----------|-----|
| US | 3.7 |
| Eurozone | 6.4 |
| Japan | 2.5 |
| China | 5.0 |
| Australia | 3.9 |

- Unemployment is either at all-time or 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 concerning levels.
- 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.

Could the Reserve Bank of Australia (RBA) raise rates?

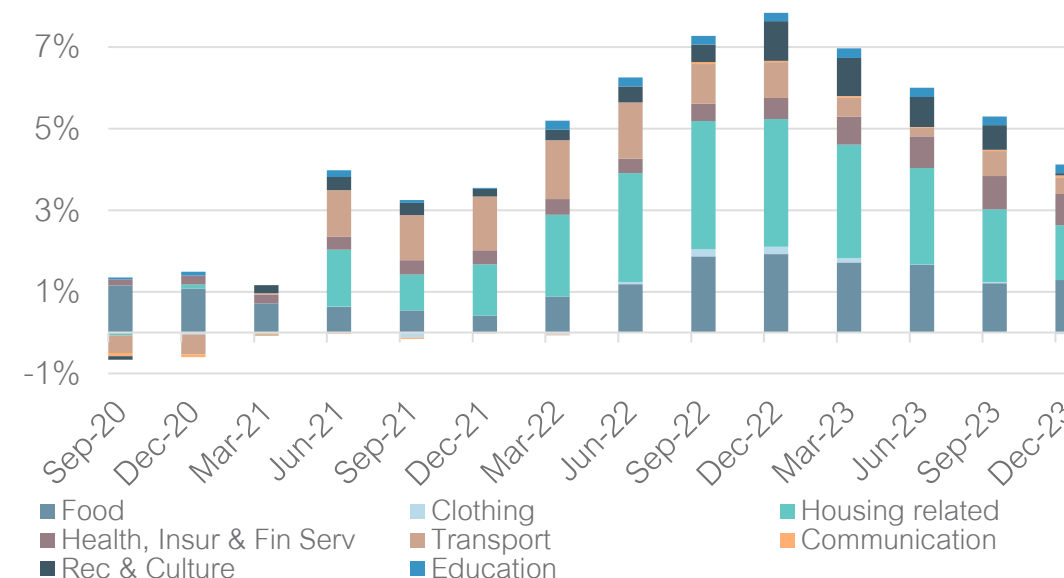
Australia already faces widespread inflation and Stage 3 tax cuts are coming

Estimated Impact of Stage 3 Tax Cuts on the Australian Economy

| Household | Tax benefit (monthly) | Consumption to Income Ratio | Annual Incremental consumption per household (\$) | Total Annual Incremental consumption (\$ millions) | Total Annual Incremental consumption % GDP |
|--------------|-----------------------|-----------------------------|---|--|--|
| 1st quintile | 35 | 111% | 424* | 675 | 0.03% |
| 2nd quintile | 111 | 86% | 1,143 | 1,818 | 0.08% |
| 3rd quintile | 200 | 82% | 1,970 | 3,133 | 0.13% |
| 4th quintile | 321 | 76% | 2,942 | 4,680 | 0.19% |
| 5th quintile | 388 | 61% | 2,860 | 4,549 | 0.19% |
| TOTAL | | | | 14,856 | 0.61% |

- Stage 3 tax cuts start from July 1.
- An estimated \$14.9 billion of the tax benefit could be spent in the first year of Stage 3 cuts, equal 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.
- Wage growth still above 4% (well above the RBA's target inflation range of 2-3%), the high level of inflation could become entrenched.

Contribution to Year-Over-Year Inflation Growth

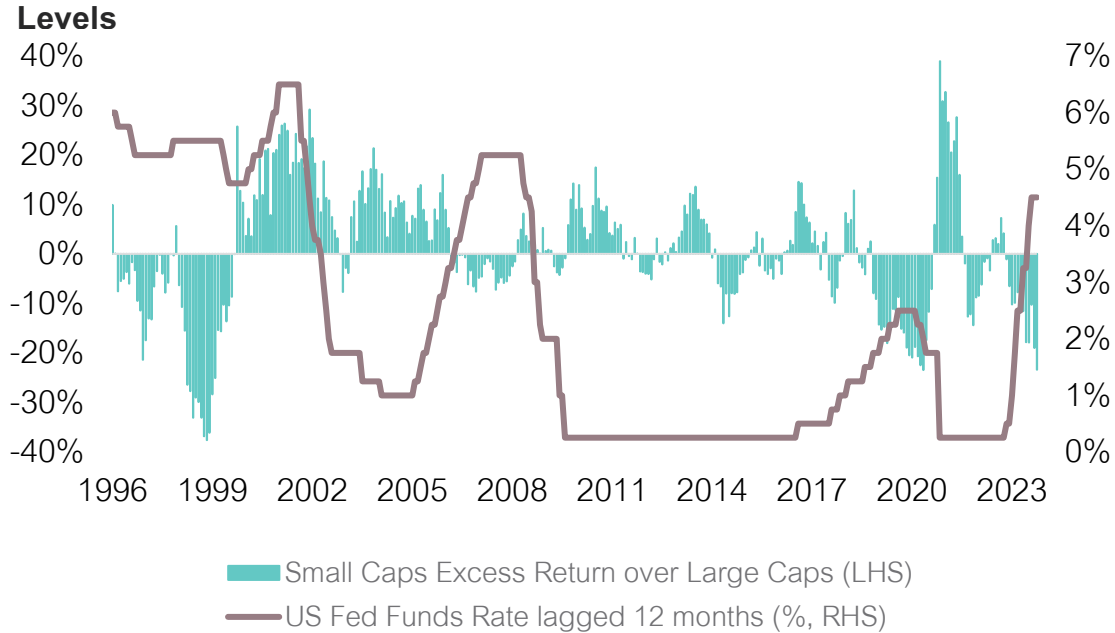


- With all underlying inflation groups still tracking higher, the potential surge in household spending could result in the Reserve Bank of Australia (RBA) raising interest rates in 2024.
- While our base case is for the RBA to remain on hold over the course of 2024, the upside risk to inflation is something we are watching keenly.

The Case for Developed Market (DM) Small Caps

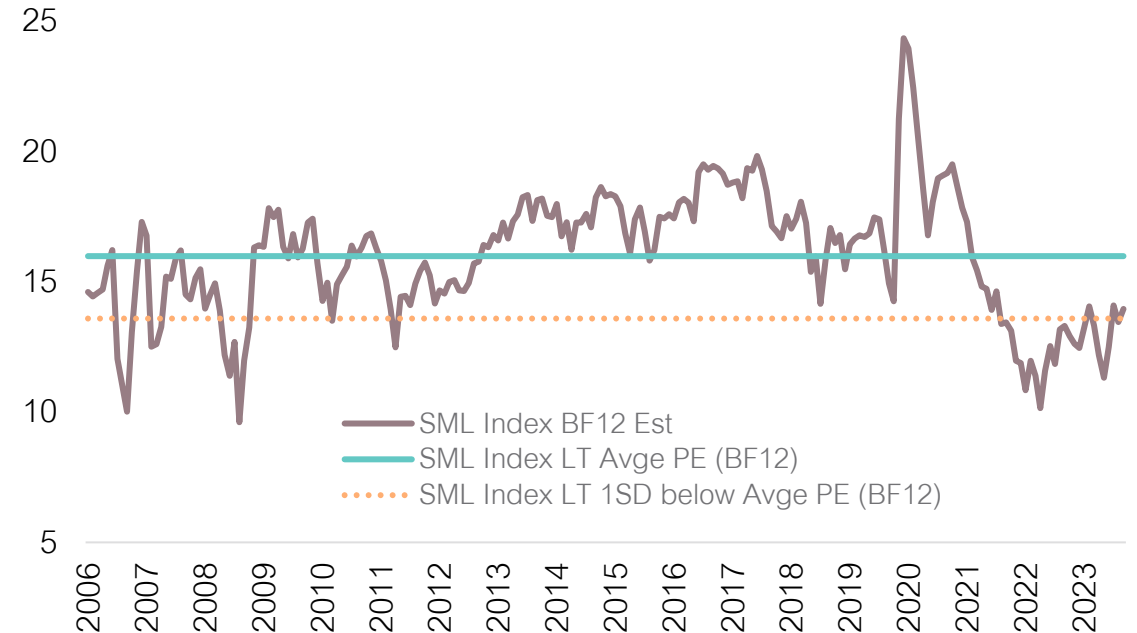
Lonsec prefers DM Small Caps over DM Large Caps

US Small Caps excess Return Over Large Caps versus US Fed Fund Levels



- Small Caps tend to outperform very early in the economic cycle, just before or as the economy shifts into expansion.
- In recent history, US Small Caps' outperformance started around the same time the Federal Reserve (Fed) cut its policy rate.

US Small Cap Forward Price/Earnings Ratio (PE)



- US Small Caps forward PE (13.9x) looks attractive from an absolute and historical perspective. US Small Caps also have stronger expected earnings growth than Large Caps (14% vs 12%)
- While DM Small Caps average forward PE looks cheap (13.9x vs long-term average 15.2x), we prefer US Small Caps as the discount to their historical average is more compelling than DM Small Caps.
- Australian Small Caps are particularly expensive (17.8x forward PE vs long term average 15.1x).

Outlook and Positioning

Central banks should begin the easing cycle but slower than expected because of persistent inflation.
Prefer DM Small Caps

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

- 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 at the expense of DM Large 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 expected gradual unwinding 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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