Lonsec

Portfolio Perspectives

Insights from the CIO Office

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Key Messages for Investors

- Recent macroeconomic data supports our expectations for a "soft landing".
- The US yield curve has set a new record for the time inverted.
- Lonsec believes the inversion reflects more than a view that inflation will be sticky.
- We believe the market is becoming increasingly weary of the unsustainable fiscal path of the US deficit.
- The Australian government can demonstrate a pathway to lower absolute and relative debt levels.
- We believe the relative fiscal performance between nations should become a more prominent factor which keeps us overweight Australian government bonds versus the US.

An inverted yield curve occurs when short-term interest rates are higher than long-term interest rates. According to a Federal Reserve Bank of San Francisco report, an inverted yield curve has preceded every US recession since 1955, except in the mid-1960s when the inversion preceded only an economic slowdown but no recession. As noted in previous Portfolio Perspectives, Lonsec is in the soft landing camp where economic growth could fall between -1% and 1%. We also note that the current inverted yield curve is the longest in history, exceeding the previous record of 622 days that preceded the 1980 recession.

If we accept that a US recession is less unlikely in the near term, why is the yield curve still inverted? We make three observations and a supposition.

******* *To help readers understand this month's Portfolio Perspective, we remind them of some basic principles of bond pricing. Remember that interest rates and principal values move inversely for fixed-rate debt securities. Even when interest rates rise, the principal value does not change for variable-rate debt.* ***

US Federal Reserve (Fed) interest rate policy direction

We believe the US Treasury issues new debt to match the market's natural tendency to prefer variable interest rate securities over fixed rates when the Fed is raising interest rates. This is because short-term Treasury securities have a floating rate. Thus, the interest it pays will increase as the Fed raises rates. However, long-term Treasury securities have a fixed rate, which means rising interest rates result in the security's principal value falling. As long as the market believes the Fed is raising interest rates, the preference for short-term treasury securities is more persistent.

US Treasury Auction - Bid to Cover Ratio

The bid-to-cover ratio is the dollar amount of bids received in a Treasury security auction versus the amount sold. It is an indicator of the strength of demand for Treasury securities. With the Fed signalling its intention to reduce interest rates this year (three times at their last meeting), why has the demand for longer-term treasury securities generally remained muted? Looking at the 5-year and 10-year auctions, the bid-to-cover ratio has decreased slightly since the Fed's pivot signal. With the current yield on the 10-year bond around 4.2%, a 0.75% reduction in the Fed's key policy rate, all else equal, would provide a ~6% lift to the principal value of the bond. Once you add the coupon payments, the annualised total return of holding a 10-year bond today is around ~10%. From our experience, a 10% total return on US treasuries has historically been very attractive.

Inflation is sticky

The US Core Personal Consumption Expenditure (PCE) recently came in at 2.8%, still well above the Fed's 2% target. Notably, the sub-segment measuring consumer spending rose 0.8% in the month, well ahead of consensus estimates for a 0.5% rise. This highlights our concern that inflation, while decelerating, is sticky and will take longer to normalise. This view extends to Australia,

where inflation is still running just under 4% as wages and rents continue to grow near mid-single-digit levels. The persistence of inflation is a factor many markets are grappling with.

Lonsec's Supposition

The inverted yield curve, taken from the point of view of supply and demand, means there is a market preference for shorter-term versus longer-term debt securities. Lonsec believes this preference is either because the market thinks inflation will be more persistent or because the market is concerned about the US fiscal path.

If the focus is on inflation, the path to interest rate cuts becomes more extended, supporting the demand for shorter-dated debt securities. While this may be true, the more significant driver is likely the market's growing discomfort with the US government's fiscal path. Recall that issuing new Treasury securities is needed to support deficit spending.

When discussing the outlook for the US deficit, the Congressional Budget Office (a US federal agency that provides budget and economic information to Congress) indicates the projected size of the deficit has only been at such levels during WWII and the coronavirus pandemic. In the absence of an existential threat like a global war or a pandemic, we are concerned the market is shying away from supporting US budgetary choices.

This is borne out from the Fed's intention to decrease interest rates, which should be driving a more significant shift towards longer-dated treasuries by now. Yet, we suspect the unsustainable deficit pathway is increasingly becoming the market's focus.

Notably, interest payments by the US government are on pace to become the third largest spending category (surpassing National Defence) in 2024. This lack of focus on spending by Republican or Democratic parties, best exemplified by Donald Trump, who wants to extend his 2017 corporate tax cuts, drives Lonsec to prefer Australian government debt in our portfolios.

Australia is reducing its supply of new debt securities as it is poised to achieve another budget surplus in FY24. Unlike the US, the Australian government can demonstrate a pathway to lower absolute and relative debt levels. We believe the relative fiscal performance between nations should become a more prominent factor when deciding on bond allocations in the fullness of time, which keeps us overweight Australian government bonds versus the US.

Outlook and Positioning

We remain in the soft-landing camp, with recent macroeconomic data and sentiment supporting this positioning. We observe generally positive but muted macroeconomic figures across countries and regions that are neither alarming nor exciting. Central banks' policy remains favoured towards loosening their monetary policies, but sticky inflation should temper the pace.

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 monitoring the weakness of the Australian dollar, any policy changes from the Chinese government to stimulate its economy meaningfully, developments in the US presidential race, and regulatory developments within the global technology sector.

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 ● (white)
New Position ● (orange)

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 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 see 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.

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