Lonsec

Portfolio Perspectives

Insights from the CIO Office

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Key Messages for Investors

- We are in the late stage of the economic cycle with economic growth in Australia moderating to 1.1% year-on-year in the March quarter, well-below trend.
- With consumer spending accounting for 50% of Australian GDP, understanding the health of the Australian consumer is key to understanding how this cycle may ultimately play out.
- Over the last year we have observed a 'two-speed consumer' whereby the impact of higher rates and cost-of-living crisis has disproportionately fallen on the younger cohort.
- Those under the age of 44 have already cut back significantly on their discretionary spending.
- The older, wealthier cohort have so far continued to spend. Benefiting from higher cash rates on savings and less debt, the above 55-year cohort in particular, have been increasing their spending on discretionary items.
- We think this older cohort will be key in determining how this cycle plays out. While they are still spending, we think the 'soft-landing' scenario remains most likely.
- Upcoming Stage 3 tax cuts and announced budgetary measures to support the younger cohort with cost-of-living pressures add additional weight to our view.

In the May CIO Perspective, we re-affirmed our view that the RBA was unlikely to cut rates before year end thanks to sticky inflation. With that in mind, we asked ourselves; is our base case for a 'soft-landing' (where growth continues to moderate in an orderly fashion to between +/- 1%) still plausible? How long can the Australian economy withstand higher interest rates amidst a broader cost of living crisis? For the answers, we turned our attention to the health of the Australian consumer.

We are in the late stage of the economic cycle with economic growth moderating to 1.1% YOY in the March quarter, well below trend. Consumer spending accounts for about 50% of Australian GDP, so understanding the health of the Australian consumer is key in determining how this cycle may ultimately end.

Two-speed Consumer

Recent updates from the major banks point to a weakening in household spending over the first 4 months of 2024. The Commonwealth Bank (CBA) Household Spending Index (HSI) weakened materially in the month of April, from 3.9% to 2.6% YOY, with spending on food & beverages (-3.8%/mth), hospitality (-3.3%/mth) and recreation (-2.6%/mth) leading the declines. The HSI Index collects month-on-month data from approximately 7 million CBA customers, representing close to 30 per cent of all Australian consumer transactions. This softness in spending is also reflected in the retail sales figures which have been broadly flat over the last 7 months.

While overall spending is slowing, the impact of higher rates and rising cost-of-living pressures has not been felt evenly across consumers according to income, wealth and age. The impacts have fallen disproportionately on the younger cohorts (44 years and under) who have, by necessity, cut back significantly on their discretionary spending over the last 12 months. This cohort tends to hold more debt (in the way of car loans, student debt, larger mortgages), lower income and less wealth than older cohorts.

According the to the CBA Household Spending Insights (HSI) Report released in May 2024, renters have reduced spending on recreation, hospitality, food & beverage goods and household services over the past year. Renters typically devote a large share of their wallet on these items (as well as rent) highlighting the very real stresses being experienced by this cohort.

While the younger cohorts are clearly spending less, at the other end of the scale, the older, wealthier cohort (45+) that has been increasing their spending over the last 12 months.

The 45-year plus cohort is also growing, now accounting for 53% of the population (up from 51.5% in 2019). To date, they have weathered higher interest rates surprisingly well. The fact that they are still spending helps explain the relative resilience of the Australian economy to date.

Breaking this cohort down further, we can see that the 45-55 year group have pulled back spending on discretionary items, but only at the margin. Meanwhile they have been increasing their spending on essential items such as insurance, health and utilities.

Mortgage holders who span all age groups but are prominent in this 45-55 cohort, have so far been surprisingly resilient to much higher mortgage rates. They have been able to build significant buffers up in offset accounts in recent years. There is now $60bn (up from $53bn in Q3 2022) sitting in offset accounts according to Westpac and $45bn (up from $38bn in 1H 2022) sitting in ANZ offset accounts. The fact that these have been growing suggests that they have adjusted well to higher rates and have actually been able to save in this environment.

Customers also remain ahead on their repayments with no significant deterioration in customers' ability to service their mortgage debt despite 13 rate rises. ANZ reported that 79% of customers are now ahead on their mortgage repayments, up from 70% in 1H of 2020.

The strength of the labour market remains key for this cohort. While they remain employed, they are managing to service those higher interest costs. However, mortgage holders will not be immune to this higher rate environment indefinitely. If we did see a deterioration in offset account buffers or an increase in customers falling behind on their repayments, that may be an indicator of a more serious economic slowdown ahead. While this is not our base case, particularly in light of Stage 3 tax cuts arriving in July and recent cost of living support measures announced in the May budget, it is something we are monitoring closely.

Finally, those in the older, wealthier cohort (55 years and above) who may be retired and own their homes outright have increased their spending by some margin over the last 12 months. Higher cash rates on savings accounts, strong equity market returns, and rising property prices have boosted the 'wealth effect' for this group.

A similar story is also playing out in the United States. There too, baby boomers who hold very little in the way of debt and have accumulated large amounts of savings are benefiting from the highest real rates seen in 20 years. Their share of consumer spending has been growing while the younger cohort, struggling from the burden of higher debt levels and cost of living pressures, have seen a significant decline.

We think this older cohort will be key in determining how this cycle plays out both here and in the US. Barring a significant hit to their wealth (such as an equity market collapse or significant falls in property prices), it is hard to see this cohort pulling back their spending anytime soon. While the boomers are still spending, we think the 'soft-landing' scenario remains most likely.

Outlook and Positioning

We remain in the soft-landing camp. Macroeconomic conditions are moderating both in the US and here in Australia but not in an alarming manner. Inflation is coming down, but it is stickier and higher than most central banks would like. We think they will be patient in cutting rates but expect most to be in a position to do so towards the back end of the year. We think the RBA on the other hand, will be on hold for the remainder of the year with Stage 3 tax cuts and recent cost of living measures announced in the May budget presenting potential upside risks to inflation.

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 employment markets for signs that labour conditions may soften and the pace of any deceleration. We are also keeping watch on the 'two-speed' consumer, in particular the older wealthier cohort that has been carrying the economy through this latter part of the cycle. We would begin to be concerned should they start to pull back on their spending in any meaningful way.

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 growth outlook for Australian equities remains muted over 2024/25 with Banks and Resources expected to deliver negative earnings growth over the period. The ongoing recovery in China and a pick-up in commodity prices presents upside risk to market earnings over FY25.
Developed Market Equities	Neutral	Global equity valuations appear stretched, particularly in the US, thanks to the stellar outperformance of the Magnificent 7 this year. But with recent reporting showing further resilience, these valuations do look more reasonable. However, the robust performance has resulted in dispersion in valuation between Small/Mid-Caps and Large Caps, with small/mid-caps looking attractively priced.
Emerging Market Equities	Neutral	Valuations look attractive relative to developed markets, but we remain cautious due to the lingering uncertainty around China. Although "green shoots" are appearing in the broader economic data, major challenges in that country's property sector continue to drag on consumer sentiment and spending. The latest government stimulus proposals are encouraging, but may not be sufficient to support a recovery.
Australian Listed Property	Neutral	Valuations for the sector as a whole are now looking full Uncertainty on the timing and direction of rate changes remain a headwind. Highly nuanced depending on sub-sector and given the structural imbalances in the benchmark, with the office sector in particularly remaining structurally challenged.
Global Listed Property	Neutral	Valuations are attractive enough to maintain a neutral position, and fundamentals on the sector as a whole are solid. Uncertainty on the timing and direction of rate changes remain a headwind. 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	We have moved to a neutral position in our private market exposure with valuation discrepancies compared to listed markets having largely unwound. 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	Neutral	Provides short term liquidity with a modest yield.

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