Lonsec

# Portfolio Perspectives

Insights from the CIO Office

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## Key Messages for Investors

- Corporate profit growth is a strong predictor and driver of higher share prices.
- US reporting season so far is very encouraging for corporate profit growth.
- However, the risk/reward for the Magnificent 7 looks more skewed to the downside the higher they rise.
- There is evidence that the market is looking elsewhere for better value.

US reporting season has kicked off, and there remains a heavy focus on the Magnificent 7. As of the date of this report, 74% of the S&P500 has reported (according to FactSet) with a combined annual profit growth of 12.6%. This underscores the strength of the US markets, as profit growth is a strong predictor and driver of higher share prices. That said, we continue to be cautious about the skewing impact of the Magnificent 7 on the S&P500.

So far, six of the Magnificent 7 have reported their latest quarterly results. In the case of four of them where the company missed or only matched consensus estimates, the share price fell after the announcement, highlighting the high expectations these companies need to deliver against. These expectations remain high, with the group average PE ratio of 40.7x for an average expected profit growth of 35% for 2024. Nvidia stands out in the group with a forecast profit growth of 114% against a 42 x PE ratio.

While we cannot predict with certainty that Nvidia (or any of the Magnificent 7) will miss these targets, we do believe that the path to achieving these lofty expectations is becoming increasingly narrow. A misstep could prove disastrous in the short term for the share price. In other words, as the Magnificent 7 climbs higher, the risk/reward for holding these stocks becomes more skewed to the downside.

We see better risk/reward opportunities beyond the Magnificent 7. The advance / decline line (A/D line), a short-term market breadth technical indicator, currently suggests the real action might be happening away from the Magnificent 7. Despite the recent decline in the S&P 500 from its July highs, the A/D line has continued to rise, indicating that more stocks are now rising than falling. How is this possible if the S&P500 overall is falling? Remember, the Magnificent 7 accounts for over 30% of the weight in the index. So, while these stocks have faced challenges in recent weeks, the other 493 stocks in the S&P500, in aggregate, are performing well. This trend is evident in the S&P 500 Equal Weight index, which has risen over 1% since early July, compared to the S&P500 index, which has fallen over 3%. Market breadth appears to be broadening.

Drilling deeper, over this same period, we also observe a growing differential between large companies (which includes the Magnificent 7) and smaller companies. Since early July, US smaller companies have outperformed US larger companies by nearly 10%. The same dynamic is playing out at a global level, with global smaller companies outperforming global large companies by 6%.

Even in Europe, despite weaker growth and a dramatic shift to the political Right as exemplified by the French elections, the market has outperformed other developed markets, including the US.

We believe the key underlying trend supporting this rotation is the growing confidence in the delivery of corporate profit growth and the recognition that there is better value elsewhere in the market.

We understand that this measurement period is relatively short, but the market movements are dynamic enough to warrant our attention and analysis.

## Outlook and Positioning

We emphasise our recent move to take 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. We reconfirm our move last month 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.

Looking ahead, the Australian earnings season will provide timely insights into the general health of the economy. We are looking for new leadership in the market as we question how much longer the big four Australian banks can drive the market, having accounted for ~60% of the S&P/ASX 200 returns year to date.

| 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 | | | ● | | | | |

## 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 | Neutral | 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 | Neutral | With cycle risks declining, we believe cash can be put to work in riskier asset classes. |

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