Lonsec

Portfolio Perspectives

Insights from the CIO Office

September 2024

Dan Moradi

Portfolio Manager, Listed Products

Lonsec Investment Solutions

Key Messages for Investors

- At the headline level, ASX100 corporate earnings grew 3.7% in FY24, with a modest uptick in growth expected in FY25 (+4.6%).
- EPS revisions in Australia have been negative YTD, in contrast to DM peers.
- Lower commodity prices have dragged forward earnings estimates down.
- Valuations for Australian equities remain elevated, while growth expectations remain subdued.
- Developed market equities currently offer a superior growth outlook over FY25.

We have been eagerly anticipating the August 2024 reporting period, looking for clues regarding the health of the domestic consumer, the impact of inflation and higher interest rates on company earnings, and the prospects for a return to growth in FY25.

At a high level, the August 2024 company reporting period that concluded last week was broadly in line with expectations, with underlying earnings at the index level (S&P/ASX100) growing 3.7% in FY24. At the sector level, earnings from ASX's largest sectors, namely banks and resources, which represent almost half the market cap of the ASX, declined by 2.0%, while EPS for the rest of the market grew by 8.4%.

Regarding themes, a resilient consumer, moderating yet persistent inflation, ongoing margin pressures, and stabilisation in the labour market dominated discussions and outlook statements over the reporting period. To date, the market seems to be navigating these headwinds relatively well, with many companies passing on the additional costs to end consumers, where possible, to protect margins. However, passing on higher costs appears to be getting more challenging, as consumers remain under pressure from the rising cost of living.

What has become evident is that despite the prolonged period of elevated living costs, the domestic consumer remains resilient. We continue to see evidence of this in the results reported by the major banks and discretionary retailers. Spending in aggregate is being supported by elevated migration, additional spending by the older cohort, and the drawdown of savings over the past year. This trend appears to have continued into the new financial year, with positive trading updates from discretionary retailers post the financial year-end. Big box retailers like JB HiFi and Harvey Norman have reported 3-5% like-for-like sales growth in July 2024, while travel agent Flight Centre stated that their international ticket sales in Australia have increased by 18% in July 2024. This strength in retail spending, possibly supported by the onset of stage 3 tax cuts and government stimulus support, will be considered by the RBA as they decide on the path for monetary policy over the second half of the year.

Despite the resilience in the results reported by the banks and retailers, it has not been smooth sailing for many companies and sectors across the ASX. Forward-looking earnings expectations across the market have been trending lower, with all but two sectors – Information Technology and Financials - seeing negative earnings revisions during the reporting period. In aggregate, market EPS has been downgraded by c.3.0% over August, reducing market EPS growth to a mediocre 4.6% in FY25. This follows a similar trend seen in FY24, with limited earnings growth expected from the market's two main segments, banks and resources.

While a continuation of low bad debts, benign asset quality, strong cost management, and the prospects of rate cuts in 2025 will no doubt help the banks maintain or slightly grow their earnings and dividends over the next 12-18 months, the earnings outlook for the resources sector does appear more challenging.

This year, concerns over China's economic slowdown have weighed heavily on the Australian mining sector. While demand for

iron ore has remained relatively stable to date, excess Chinese steel production and unseasonally elevated iron ore port inventory in China are signalling short-term headwinds for Australian iron ore miners. Iron ore prices have recently broken through the US$100/t barrier, indicating further downside risk to prices over the second half.

From a bottom-up perspective, expectations for positive earnings growth for the iron ore miners in FY25, which had relied on iron ore prices remaining above US$100/t, are being hastily downgraded. Based on our estimates, earnings risks remain skewed to the downside, with current mark-to-market earnings projections 10-15% lower for BHP in FY25.

The growth outlook for the industrial universe on the ASX (ex-banks and resources) looks much more appealing heading into FY25. Earnings are expected to grow by 9.4%, driven by double-digit growth from higher-growth sectors, including Healthcare and Information Technology. This seems appealing at face value; however, a forward PE multiple of 28x for this cohort more than captures the forward growth trajectory. In our view, this leaves a narrow path to outperformance for the ASX over FY25.

Outlook and Positioning

Global markets have bounced back strongly after the volatility spike at the start of August. The US Q2 reporting season was encouraging, with initial signs of a broadening in earnings delivery. Market EPS growth, excluding the Magnificent 7, turned positive for the first time since the fourth quarter of 2022.

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.

Domestically, FY25 is shaping up to be another lacklustre year from a growth perspective for Australian Equities. A recovery in earnings would most likely need to be driven by the Resources sector, supported by an economic recovery in China, which may push the recovery out to FY26 given the current uncertainty around China and its growth outlook.

This tepid outlook for Australian equities in FY25, combined with the significant divergence in the valuation and outlook for the various sectors on the ASX, highlights the importance of active portfolio management and reinforces our relative preference for Developed market equities, particularly US Small Caps.

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 continue 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 opened 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 relative to other markets, emerging markets currently appear fairly priced, with main valuation metrics in line with their long-term average. However, with so much uncertainty around China and its growth outlook, risks look 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 the current cyclical dynamics at play.
Conservative Alternatives	Neutral	Gold acts as a risk-diversifier against 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.

Important Notice: This document is published by Lonsec Investment Solutions Pty Ltd (LIS) ACN: 608 837 583, a corporate authorised representative (CAR number: 1236821) of Lonsec Research Pty Ltd ABN: 11 151 658 561 AFSL: 421 445 (Lonsec Research). LIS and Lonsec Research are owned by Lonsec Holdings Pty Ltd ACN: 151 235 406. LIS creates the model portfolios it distributes using the investment research provided by Lonsec Research but has not had any involvement in the investment research process for Lonsec Research. Please read the following before making any investment decision about any financial product mentioned in this document.

Disclosure at the date of publication: Lonsec Research receives a fee from the relevant fund managers or product issuers for researching financial products (using objective criteria) which may be referred to in this document. Lonsec Research may also receive a fee from the fund manager or product issuer (s) for subscribing to research content and other Lonsec Research services. LIS receives fees for providing investment consulting advice, approved product lists, model portfolios to financial services professionals and other advice to clients. LIS' and Lonsec Research's fees are not linked to the financial product rating(s) outcome or the inclusion of the financial product(s) in model portfolios. LIS, Lonsec Research and/or their associates may hold any financial product(s) referred to in this document, but details of these holdings are not known to the analyst(s).

Warnings: Past performance is not a reliable indicator of future performance. Any express or implied rating or advice presented in this document is limited to "general advice" (as defined in the Corporations Act 2001 (Cth)) and based solely on consideration of the investment merits of the financial product(s) alone, without taking into account the investment objectives, financial situation and particular needs ("financial circumstances") of any particular person. Before making an investment decision based on the rating or advice, the reader must consider whether it is personally appropriate in light of their financial circumstances or should seek independent financial advice on its appropriateness. If the advice relates to the acquisition or possible acquisition of a particular financial product, the reader should obtain and consider the Investment Statement or the Product Disclosure Statement for each financial product before making any decision about whether to acquire the financial product.

Disclaimer: LIS provides this document for the exclusive use of its clients. It is not intended for use by a retail client or a member of the public and should not be used or relied upon by any other person. No representation, warranty or undertaking is given or made in relation to the accuracy or completeness of the information presented in this document, which is drawn from public information not verified by LIS. Financial conclusions, ratings and advice are given on reasonable grounds held at the time of completion (refer to the date of this document) but subject to change without notice. LIS assumes no obligation to update this document following publication. Except for any liability which cannot be excluded, LIS and Lonsec, their directors, officers, employees and agents disclaim all liability for any error or inaccuracy in, misstatement or omission from, this document or any loss or damage suffered by the reader or any other person as a consequence of relying upon it.

This report is subject to copyright of LIS. Except for the temporary copy held in a computer's cache and a single permanent copy for your personal reference or other than as permitted under the Copyright Act 1968 (Cth), no part of this report may, in any form or by any means (electronic, mechanical, micro-copying, photocopying, recording or otherwise), be reproduced, stored or transmitted without the prior written permission of LIS.

This document may also contain third party supplied material that is subject to copyright. Any such material is the intellectual property of that third party or its content providers. The same restrictions applying above to LIS copyrighted material, applies to such third-party content.

Copyright © 2024 Lonsec Investment Solutions Pty Ltd