Portfolio Perspectives

Insights from the CIO Office

October 2024

Key Messages for Investors

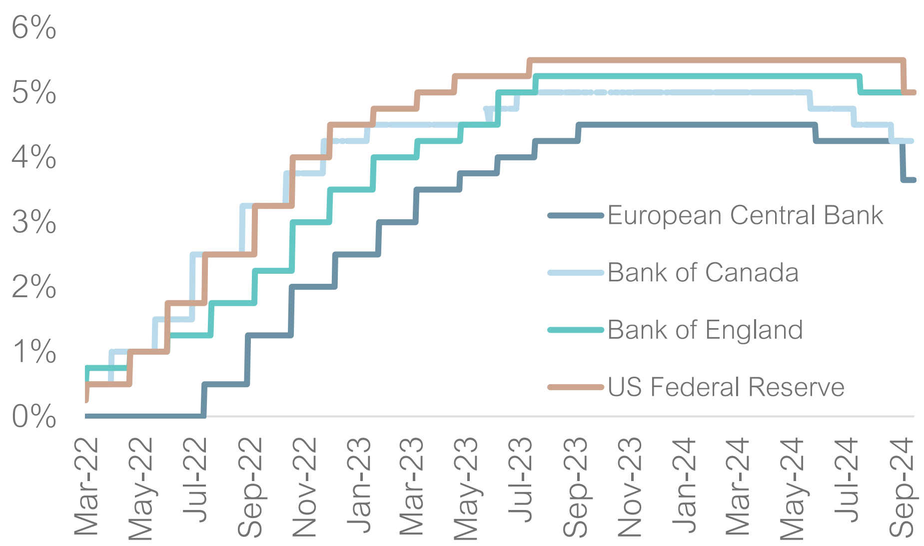
- The interest rate cycle has turned, the loosening of monetary conditions acts like a lubricant for capital
- Global Listed Infrastructure valuations are attractive and headwinds have subsided
- Global Listed Property is a nuanced sector with opportunities beyond Office, consider an actively managed allocation
- Australia's earnings outlook is muted and faces downside risk – China supply-side stimulus noted but needs a demand response from households
- Moving Global Listed Infrastructure to Neutral, Global Listed Property to Slight Overweight Australia to Slight Underweight

The interest rate cycle has turned

Lonsec

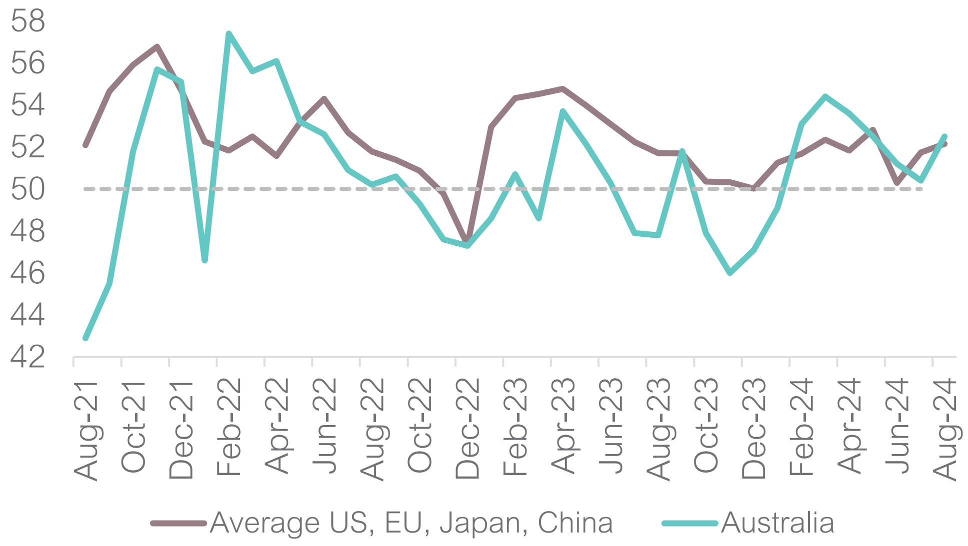
Loosening monetary conditions lubricates capital making it cheaper and boosting the economy

Major Central Banks have begun to cut their key policy rate



- The interest rate cycle has turned, the recent 0.5% reduction by the US Federal Reserve (Fed) solidified this view, in our opinion.
- Major Central Banks that have begun cutting their key policy rate: US Federal Reserve, European Central Bank, Bank of Canada, Bank of England, Swiss National Bank, Riksbank (Sweden), and Reserve Bank of New Zealand.
- This presents a promising opportunity for growth in the real estate and infrastructure sectors, making it an optimistic time to reconsider these assets for portfolios.

Services Purchasing Manager Index remains above 50



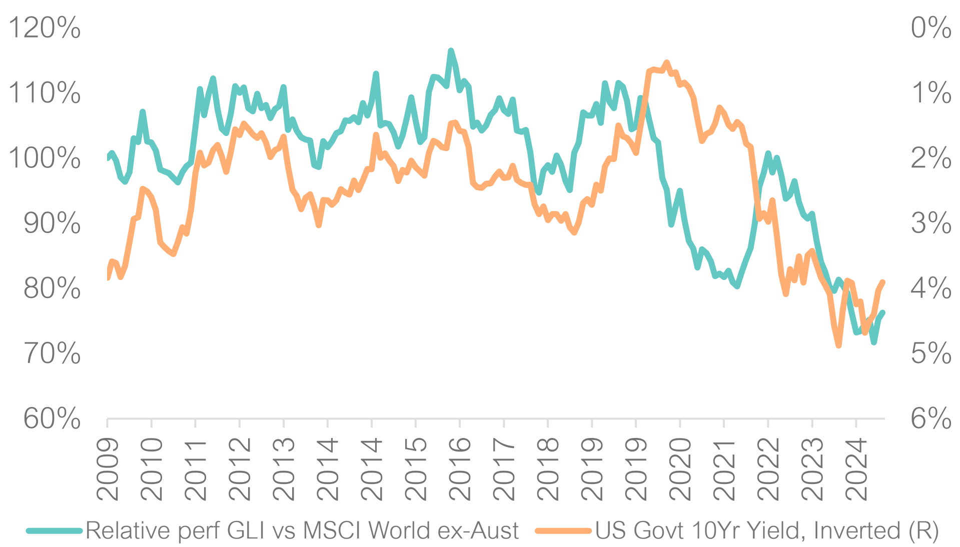
- The direction of the Services portion of the economy is pivotal for its outlook. A simple average of the Services Purchasing Managers Index (PMI) of the US, Eurozone, Japan and China remains above 50, the critical threshold demarking expansionary or contractionary conditions.
- Recall that the services portion of US, EU, Japan and China on average makes up around 2/3 of their respective economies – services is the driver of growth.
- This measure has only dipped below 50 once since at least 2021. While the current average is only a modest 52.2, even a soft expansion in the services sector can underpin global growth.

Source: Factset, Bloomberg, Lonsec estimates.

The case for Global Listed Infrastructure (GLI)

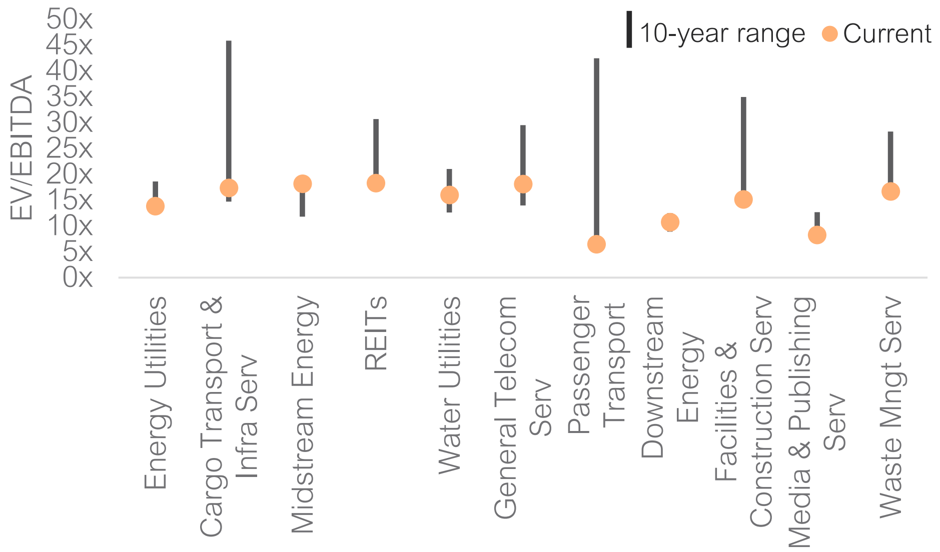
Global Listed Infrastructure valuations are attractive and headwinds have subsided

GLI has historically outperformed the broader market in a lower interest rate environment



- Global Listed Infrastructure, as a sector, has underperformed global equities since 2022
- Higher interest rates have created a headwind for the sector as elevated debt levels led to higher interest payments and a negative impact on infrastructure asset valuations.
- Historically, falling interest rates have been a tailwind for the sector.

Sub-sector valuations at 10-year lows



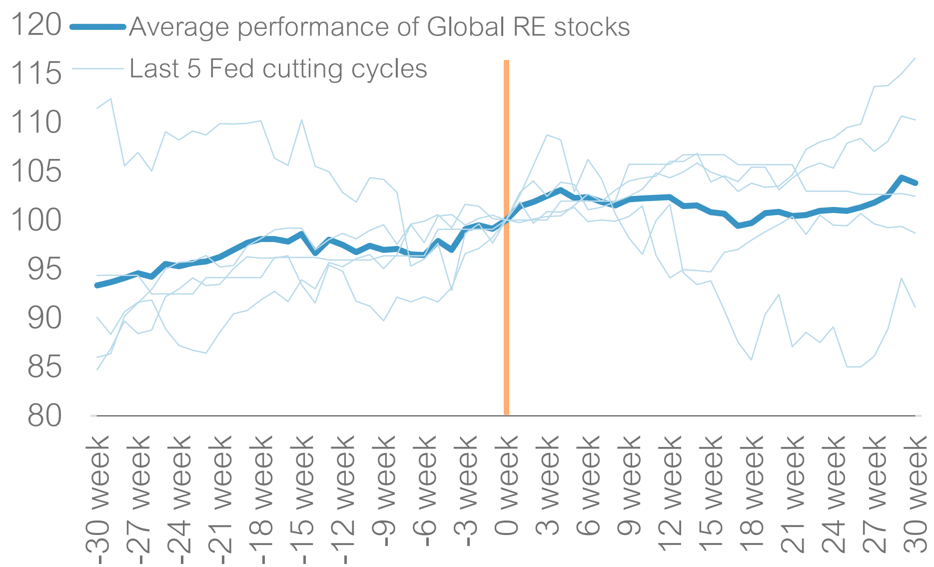
- Many globally listed infrastructure companies currently trade at the lower end of their historical valuation multiples.
- Earnings growth within GLI is likely to be underpinned by several structural growth themes over the coming years, including renewables, battery storage, electricity transmission, data centers, and the rise of the digital economy.

Source: VanEck, FactSet, Bloomberg, FTSE, Lonsec estimates.

The case for Global Listed Property

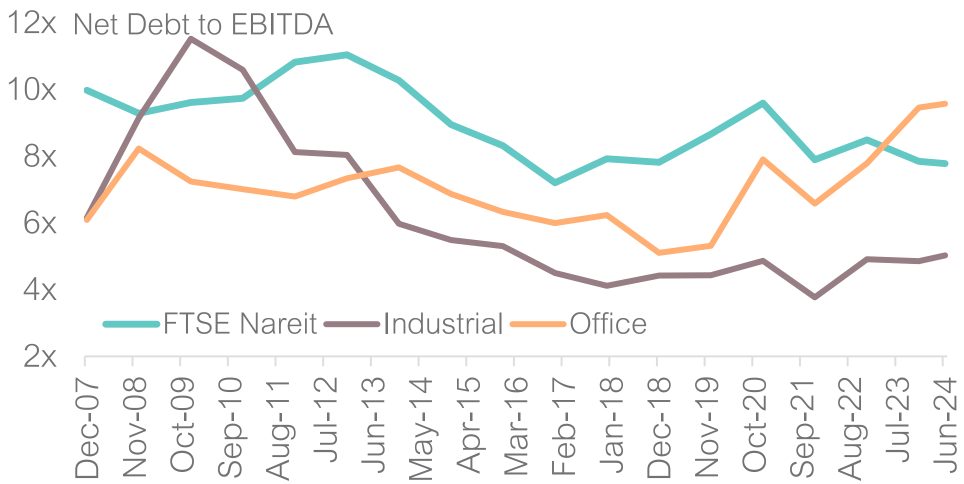
Look beyond Office

Easing cycle a tailwind for Real Estate (RE) stocks

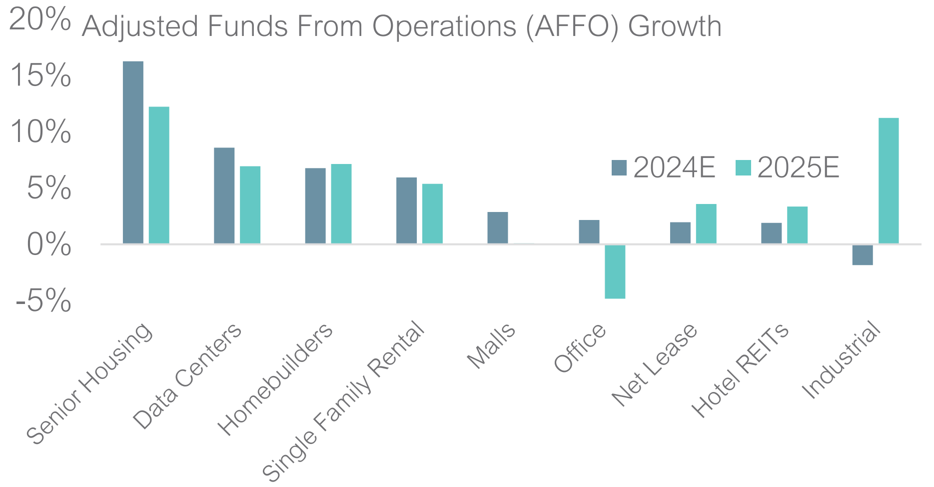


- Historically, an easing cycle has led to sector outperformance in the periods immediately after the first cut. The sector has tended to anticipate this change in policy rates about 18 to 24 weeks beforehand.
- Pattern repeated with the MSCI US REIT Index outperforming the S&P 500 by ~7%, returning 16.5% over the past six months. This underscores the potential of RE assets to continue outperforming as history could be repeating
- Challenges of Office well understood – subsector only makes up around 5% of global benchmarks.

Sector much healthier since the Global Financial Crisis except Office



Distribution growth varies across subsectors, Office notably weak



Source: Factset, Bloomberg, Macquarie Asset Management, Lonsec estimates.

The case against Australia

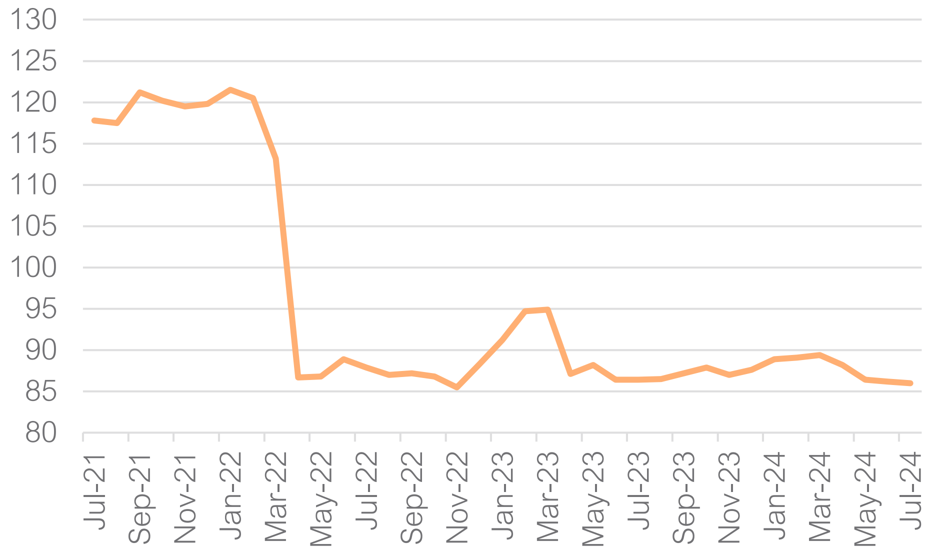
Absent a catalyst, what takes the Australian equity markets higher?

The Australian stock market can be broken down into 3 broad sectors – 50% of the market faces earnings growth challenges

Sector	% of Market	FY25 Forecast Profit Growth	FY25 PE Ratio
Financials	30%	0.2%	18x
Resources	20%	-10.5%	12x
Industrials	50%	9.6%	29x
Market	100%	2.7%	22x

- Financials primarily exposed to the slow-moving residential mortgage market. Benefit of solid credit quality already reflected in profits, there are no material levers for the banks to improve their outlook dramatically.
- Resources face looming mark to market risk. We estimate BHP’s consensus forecasts would be 10-15% lower at US$90 for iron ore.
- The growth expected in Industrials seems largely reflected in the 29x multiple.

Chinese consumer confidence remains near all-time lows



- Recent Chinese stimulus package resulted in a sharp rally in commodity-related stocks. Measures are a step in the right direction.
- Broad consensus the Chinese authorities have reprioritised the economy's health but with a focus on supply-side factors.
- Unless companies and households have the confidence to put risk assets to work, we are sceptical of the longevity of this current rally in China and resources stocks.

Source: FactSet, Bloomberg, Lonsec estimates.

Outlook and Positioning

Lonsec

The interest rate cycle has turned creating a tailwind for equity markets. Overweight Global Listed Property as there is more to the sector than Office. Australia's profit growth relative to peers is challenged.

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			●				

● Current ○ Previous

Growth Assets

- DM Equities. We are taking a constructive approach to risk but retain the overall Growth/Defensive split at Neutral.
- DM Equities. The distortion caused by the Magnificent 7 in the US has us preferring Europe and Japan given more attractive valuations.
- DM Equities. DM Small Caps typically move ahead of the turn in the economic cycle, and US Small Caps, in particular, have responded positively to the Fed starting its easing cycle. This leads to a Slight Overweight DM Small Caps with a preference for US over ex-US Small Caps.
- Global Listed Infrastructure. Back to Neutral as the interest rate cycle is no longer a headwind.
- Global Listed Property. Slight overweight as the sector should benefit from the turn in the interest rate cycle. Office is challenged but only represents ~5% of the overall market.

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 end of YCC policy in Japan should lead to an extended period of relative underperformance in Japanese Government Bonds.
- Start to easing cycle reduces the relative attractiveness of floating rate yields.
- Maintain an allocation to gold as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.

Lonsec