Lonsec

Portfolio Perspectives

Insights from the CIO Office
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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

We wish to acknowledge and thank James Maydew, Macquarie's Head of Global Listed Real Estate and Andrew Parsons, Chief Investment Officer at Resolution Capital for their contribution and collaboration in this month's Portfolio Perspective.

The interest rate cycle has turned, as evidenced by the number of Developed Market Central Banks that have cut their key policy interest rate. The recent 0.5% reduction by the US Federal Reserve (Fed) solidified this view, in our opinion. The start of a loosening in monetary conditions acts like a lubricant for capital, making it cheaper to borrow and boosting the valuation of long-duration assets. 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.

The Case for Infrastructure Assets

Global Listed Infrastructure, as a sector, has underperformed global equities since 2022, coinciding with the post-COVID inflation spike, despite infrastructure assets traditionally regarded as efficient inflation hedges. The start of the US Federal Reserve's interest rate hiking cycle in March 2022 instead created a headwind for the sector as elevated debt levels led to higher interest payments and a negative impact on infrastructure asset valuations. So, while assets continued to report solid mid-single-digit profit growth as inflation rose, leveraged balance sheets led to sector underperformance. Notably, this pattern of underperformance in a rising interest rate environment merely echoed recent experiences in 2013 and 2018 when the long term US interest rates were also rising.

After such an extended period of underperformance, the sector's attractive valuations warrant a re-examination. Historically, falling interest rates have been a tailwind for the sector, and many global listed infrastructure companies currently trade at the lower end of their historical valuation multiples. This leads us to believe that the sector is well-positioned to outperform as we head into the final quarter of 2024 and the next year. Over the longer term, global listed infrastructure is expected to benefit from the decarbonisation theme, offering a broad opportunity set that includes renewables, battery storage, electricity transmission, data centres, and the rise of the digital economy.

Accordingly, we have neutralised our underweight exposure to the sector.

The Case for Real Estate (RE)

Global Listed Property, despite requiring significant investment and being susceptible to the cost of borrowing, is now benefiting from falling policy rates. 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. This 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.

We prefer Global Listed Property to Australian Listed Property, given that the Reserve Bank of Australia seems a long way off before it will begin to cut the cash rate. Also, the sector in Australia lacks the depth and breadth of opportunities afforded in global markets. For example, commercial offices are facing an existential crisis as companies have changed how they use their space in the post-COVID era, leading to occupancy and rental growth challenges. However, as often as we are reminded by how bad Office is, Office only makes up around 5% of global benchmarks so while it does not drive the sector, it has captured the narrative. There are opportunities abound outside of Office as evidenced by subsectors that are experiencing high single-digit Adjusted Funds from Operations (AFFO) growth, like seniors housing, data centres and single-family rentals (AFFO is used to calculate the value of assets and to gauge the ability for a company to pay distributions). Additionally, the sector in aggregate has been much healthier since the Global Financial Crisis (GFC), but Office again is a standout in terms of weakness in the RE sector.

Our preferred way to view the sector is to differentiate between cyclical and secular exposures. Cyclicals' performance depends on the health of the economy, labour conditions and interest rate levels, which means investors do not typically own them throughout the economic cycle. Office is an example of a cyclical sector that you should seek to avoid for now. Secular winners, on the other hand, focus on non-cyclical considerations like demographics, supply chain realignment, and data management.

Demographics

According to the UN World Prospects 2022 report, the share of people aged 65 and older will rise from 10% in 2022 to 16% in 2050. This means that globally, we add around 76,000 people over 65 every day. The US alone adds around 10,000 each day to the ranks of those over 65.

Senior Housing is a natural beneficiary of an aging population. In the US, new construction starts are 75% below their peak levels as construction costs have exploded (a common challenge across the entire RE industry), and the cost of capital is still too high, leading to a shortage of new supply. The imbalance between an aging population and limited supply has reportedly driven 20% rental income growth. Sadly, another factor driving rental growth is "memory care", which is more expensive and is housing targeted at residents who have dementia, reportedly representing 1 in 4 new residents.

Amongst the younger cohort, the rental of single-family residences is another area of focus. Like generations before them, as they age, their family grows, which drives the shift from multi-family (apartments) to single-family (houses). However, this cohort is also at the front line of the cost of living crisis. Combined with a lack of new housing supply and interest rates still high in an absolute sense, this cohort is being driven to rent houses to accommodate their growing families, who support the growth in rents.

Supply Chain Realignment

E-commerce has transformed how we shop. Shopping online and then getting home delivery is not going away. However, there remain physical realities that have not changed. Some retail services must be conducted physically (like your dentist and hairdresser). Home delivery is more costly to perform the further away you are from the customer. Digital fulfillment is complex and expensive, meaning retailers make more money when you buy in-store versus online. Also, a significant new mall has not been built in the US since 2010 despite vacancies at multi-decade lows.

The opportunity here is two-fold: focus on Industrial/warehouse space and revisit retail shopping malls. Development profits for warehouses are reportedly between 20-40% as demand for the best-placed properties drives rental growth. For malls, the recent collapse of retail group Bed Bath & Beyond demonstrated the demand for brick-and-mortar stores remains robust as all their space was rapidly re-leased at rents 20-30% higher for mall owners across the US.

E-commerce challenged retailers to adapt, but the physical world still influences how people will always shop.

Data Management

The long-standing oversupply of data centres has started to dissipate as rental growth has returned to this part of the sector at around 4-6%. A scarcity of locations near low-cost energy sources limits the scope of new supply. Technology companies' capex budget drives the demand for space as everyone builds capacity for more cloud-based computing and the growing use of Artificial Intelligence.

Office

Even though the challenges of high vacancy and weak rental growth permeate the office sector, specialist investors are seeing pockets of opportunity. For example, 90% of the vacancy in the UK is in 5% of the national stock and capitalization rates in San Fransisco are over 10%, suggesting valuations are becoming attractive again in the Bay Area. The sector faces significant challenges for years to come, but pockets of opportunity are beginning to present themselves.

Moving to Underweight Australia

After the recently concluded Australian corporate profit reporting season, consensus estimates for FY25 profit growth have continued to slide lower and are now around a very modest 3.0%; however, the composition of that growth is worrying.

Remember, we can break up the Australian stock market into three broad groups: Financials, Resources and Everything Else (generally called "Industrials"). The share of Financials, Resources and Industrials as a percentage of the entire market is approximately, 30%, 20% and 50%, respectively. For FY25, we estimate that profit growth for Financials, Resources and Industrials is 0.2%, -10.5% and 9.6%, respectively.

Given the sector's broad exposure to the slow moving residential mortgage market, we see little scope for the Financials sector to surprise to the upside. With the benefit of solid credit quality already reflected in profits, there are no material levers for the banks to improve their outlook dramatically.

The recent Chinese stimulus package announced in late September has seen a sharp rally in commodity-related stocks, as the Chinese stock market has already risen around 12% in just the last three trading days of September. While there is broad consensus that the Chinese authorities have reprioritised the economy's health, the focus appears to be on supply-side factors like increasing the ability and cost of new financing for businesses and households. We agree that the stimulus measures are a step in the right direction. Still, 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. For example, providing more investment capital when industrial oversupply exists in many sectors does not directly encourage customers to buy more goods. We will continue to monitor for a shift in China sentiment. However, if we applied the current iron ore price to BHP's FY25 profit forecast, profits would be 10-15% lower, highlighting the overall downgrade risk for the Resource sector.

While profit growth in the Industrials sectors is attractive at 9.6%, with a PE ratio of around 29x, the growth looks to be largely in the price already.

Faced with potential limited upside for the Financials and Industrials sectors and no certainty that recent Chinese stimulus will awaken consumers and companies, we expect Australian equities to underperform other growth assets.

Outlook and Positioning

We have neutralised our underweight exposure to Global Listed Infrastructure.

We are qualifying our call to consider Global Listed Property in portfolios. Parts of the sector face long-term structural challenges, so we recommend that investors consider an active approach to investing in this sector. Seeking specialist investors with expert knowledge and local insight will be vital in navigating the opportunities in this sector.

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.

In addition to neutralising our slight Underweight to Global Listed Infrastructure, we move to slight Overweight to Global Listed Property. This is funded by reducing our allocation to Australian Equities.

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 recent stimulus announced by the Chinese government has brought optimism to markets that the Chinese economy is poised to turn higher. If China's demand conditions improved, this would mitigate some of our growing concerns that the Australian market lacks a catalyst to close its relative underperformance against other Develop Market equities. Without China or other significant catalyst, the Australian Financial and Resources sectors (which make up about half of the market) face limited growth prospects and stretched valuations, especially for the major banks.

Growth Assets	Underweight			Neutral		Overweight	
Australian Equities			Current	Previous			
Large Caps				Current			
Small Caps				Current			
Developed Market Equities					Current		
Large Caps				Current			
Small Caps					Current		
Emerging Market Equities				Current			
Australian Listed Property				Current			
Global Listed Property				Previous	Current		
Global Listed Infrastructure			Previous	Current			
Growth Alternatives				Current			
Defensive Assets	**Underweight**			**Neutral**		**Overweight**	
Australian Bonds					Current		
Global Bonds				Current			
Diversified Income				Current			
Conservative Alternatives				Current			
Cash			Current				

Current ● Previous ●

Growth Assets

Asset Class	Position	Rationale
Australian Equities	Slight Underweight	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. Recent China stimulus must translate to improve business and consumer sentiment before we will get constructive on the Resource sector.
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 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 continue 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	Slight Overweight	Attractive subsector valuations warrant an active approach to this sector. Office sector remaining structurally challenged but rental growth and healthy fundamentals are appearing in other areas of the sector (age care, data management, supply chains).
Global Listed Infrastructure	Neutral	As major developed market Central Banks have started cutting their key policy rates, a key headwind to the sector is gone. Valuations are attractive versus long term averages.
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	Slight Underweight	With cycle risks declining, we believe cash can be put to work in riskier asset classes.

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