Lonsec

Portfolio Perspectives

Insights from the CIO Office

December 2024

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Key Messages for Investors

- 2024 was marked with conflict and a political shift to the Right
- Global equity markets saw strong gains in 2024; the Australian share market lagged global peers
- It's too early to predict the economic impact of Donald Trump's victory
- Early indicators suggest the next economic cycle may already be underway
- Australia is lagging the economic cycle and must look to China for a potential catalyst

2024 in Review

Ongoing hotspots in both Israel and the Ukraine marked 2024. Hamas initially launched its attack on Israel in October 2023, and since then, the response from Israel has only recently let up with a shaky ceasefire declared on November 27.

After entering the Ukraine back in February 2014 when Russia took the Crimea region, it resumed its expansion in February 2022 and fighting there has not ceased. It has further escalated with North Korea sending troops to support Russia, followed by Ukraine striking deeper into Russian territory with US, French and UK-made missiles.

Vladimir Putin began his fifth term as Russian president in May, which saw no change in their foreign affairs stance.

Around this time, we saw a series of significant far-right political gains in Austria, France and Germany, as well as dozens of violent race riots in England and Northern Ireland, which alarmed many as their radically conservative and ultra-nationalist policies, stood in sharp contrast to Europe's traditionally progressive and inclusive views.

And, of course, Donald Trump is President-elect as the Republicans have just swept the US national elections.

Despite the barrage of negative headlines, most major equity markets continued their upward march in 2024. Year to date, the MSCI World ex-Australia and S&P500 are up 21% and 27%, respectively, while the Australian stock market has lagged the rest of the world, up 15%.

This brings us to today

The interest rate cycle has turned, and the start of a loosening in monetary conditions acts like a lubricant for global capital, making it cheaper to borrow and boosting the valuation of long-duration assets.

We maintain our view that the broader world economy is in - reasonable health, as evidenced by the average reading of the Services Purchasing Managers Index (PMI) for the Big 4 (the US, China, Europe and Japan, which represent 61% of global GDP), remaining firmly over 50, indicating expansion.

Supporting the services economy is household spending. Retail sales, which serve as a helpful proxy for spending, have hung in there across the Big 4 despite higher costs of living. We expect consumer sentiment to improve further as interest rates come down, providing additional support to consumption.

Expanding our lens to the manufacturing sector (or the rest of the economy) here, we see improving trend growth in global industrial production, as the physical production for goods and hard assets shows signs of recovery. These indicators suggest the next economic cycle may have already commenced. Said another way, we are leaving a period of weak economic growth and potentially at the point when economic activity begins to accelerate. For Lonsec, this means our focus is no longeron defence or

capital protection; instead, it is where and when we may put more risk to work in the new year. For now, we focus on building out supporting evidence around this procyclical view.

Positioning for a Trump Presidency

Back in July, we wrote:

> *"The rise of the political Right in Europe is coming at the expense of the Centre. Lonsec believes the shift towards the Right is consistent with the global trend towards more populist politics on the back of rising inequalities, which has led to increasingly inward-looking policies, protectionism and more pronounced strategic choices. It is too early to be definitive that a shift Right will equate to dramatically different European policy and budgetary settings. This is because of the high probability of the formation of minority governments, which is where the polls suggest France will land, for example. A more fragmented political landscape ensures slower change and mitigates any economic downside to limiting trade flows. "*

With President-elect Trump -presiding over a Republican Congress, we continue to take a very similar view to what has since transpired in Europe, in that the road from political victory to policy implementation is long and winding. It remains too early to take high-conviction positions, even in a diversified portfolio. Trump's tax and spending plans have been well broadcasted, but it is difficult to distil which policies are a serious threat versus those which are simply a starting point for negotiation. It is important also to remind investors of how the market reacted when the Truss government in the UK tried to ram through an unsustainable budget in September 2022. Following the release of the mini-budget, the British Pound immediately fell 8%, and about a month later, Lizz Truss stepped down and became the shortest-serving Prime Minister in the UK of all time. It is important to remember that the market gets a vote, too!

Trump's tariff plans represent the greatest risk to our base case. Recall that the last limited tariffs imposed by Trump on China and selected countries and regions reduced the global stock market by 7% and coincided with a reduction in global GDP growth by 1.3% over 2018. Global GDP is currently growing around 1.2%, suggesting an aggressive 20% tariff on all US imports could push the world economy into recessionary conditions. Given the competing priorities for a new administration, it seems unlikely that Trump would prioritise such adverse outcomes so early in his presidency.

In keeping with our view that the road from political victory to policy implementation is long and winding, there are a couple of observations worth highlighting since Trump became President-elect. Republican Senators have already blocked Trump's choice of Senate leader (Gaetz). Mexico responded to Trump's recent threats to raise tariffs. The Mexican president reminded him that US automakers were major exporters from Mexico. 76% of the 3.5 million cars manufactured in Mexico go to the US as well as 95% of all trucks. Also, approximately half of the parts that go into those vehicles came from the US. We suspect the typical Trump supporter is likelier to work at a machinery plant in the Midwest than as a programmer in Silicon Valley.

Australia's share market tied to China's recovery

Australia is taking a different path. With inflation in Australia still outside the target band for the Reserve Bank of Australia (RBA), we believe we are still a long way from the first RBA cut.

We characterise much of the stimulus announcements made by the Chinese government as supply-side focused and have lacked the strength to turn the economy materially. Without strong end demand, this is bad for Australia as a catalyst is required to reignite China's appetite for Australian natural resources.

We have heard from our Emerging Market fund managers about "green shoots" in China. You have to squint a little at the data, but retail sales and corporate profits have ticked higher in recent months. One manager even highlighted that food delivery was improving as a further sign that the consumer was recovering. These anecdotal observations are encouraging, but we have yet to revisit our positioning in China.

The nexus with Australia's share market is best seen by asking what pushes the Australian equity market higher.

FY25 profit growth forecasts are now around a modest 3.2%, down from 4.6% just a few months ago. Consider also that we can break the ASX into three groups: Financials, Resources and Industrials. For FY25, we estimate that profit growth for Financials, Resources and Industrials is 2%, -10% and 9%, respectively. This means half of the market faces either near zero or negative earnings growth.

The largest part of the Financial sector is the major banks, which have performed exceptionally well over the past year, gaining over 50% and carrying the ASX to an all-time high. However, earnings growth was not there, with the sector reporting peak earnings in FY23 and then followed by -2.4% growth in FY24. This has driven the sector valuation to an all-time high, with the majors trading on a forward PE ratio of 18x or 2x book value - a relatively expensive valuation compared to history and fundamental valuation metrics.

While the major banks' most recent results in November highlighted a continuation of good credit quality and strong cost management, earnings growth expectations remain muted at ~2% over the next two years, leaving little room for valuation upside from current levels.

So if we can't rely on the banks to take the market higher from here, a recovery in aggregate market earnings would likely need to be driven by the Resources sector. However, China's economic slowdown has weighed heavily on the sector, driving earnings growth expectations into negative territory. As mentioned, we need to see a decisive turn in Chinese policy towards demand-side/consumer-focused policy or an outright recovery to see a positive catalyst for corporate profit growth from the domestic resources sector.

Outlook and Positioning

We have not made any changes in our Dynamic Asset Allocation this month. Overall, we are Slightly Overweight Growth Assets as the start of the interest rate easing cycle should create a tailwind for risk and valuations for long-duration assets.

It is worth highlighting that absent a catalyst, we continue to expect Australian Equities to underperform Developed Market Equities. We express this view by remaining slightly Underweight Australian Small Caps, which have many unprofitable miners who should continue to struggle without solid commodity demand from China.

We have positioned for the turn in the interest rate cycle with our Overweight allocation to Large Cap Developed Market Equities and highlight our ongoing preference for US Small Caps over ex-US Small Caps. We expect Global Listed Property to be another beneficiary of the turn in the interest rate cycle.

Going into 2025, the next key event for markets will be the inauguration of Donald Trump as the next US president. It will be from this point that we will start to be able to better judge what has been posturing versus policy.

Continue to trust your well-diversified portfolio. In times of heightened market volatility and uncertainty, it is essential to remember your long-term financial goals and stay true to your risk profile. Investors should always focus on their long-term financial objectives, especially during periods of financial anxiety.

From all of us at Lonsec Investment Solutions, we thank you for the trust you place with us and for your ongoing support. We want to wish you and your family a very happy holiday.

The next edition of Portfolio Perspectives will be published in early February 2025.

Current Dynamic Asset Allocation (DAA) Positioning

Growth Assets	Underweight			N	Overweight		
Australian Equities – Large Cap				●			
Australia Equities - Small Caps			●				
Developed Market Equities – Large Caps						●	
Developed Market Equities - Small Caps				●			
Emerging Market Equities			●				
Global Listed Property					●		
Global Listed Infrastructure				●			
Growth Alternatives				●			
Defensive Assets	**Underweight**			**N**	**Overweight**		
Australian Bonds					●		
Global Bonds				●			
Diversified Income			●				
Defensive Alternatives				●			
Cash			●				

Growth Assets

Asset Class	Position	Rationale
Australian Equities – Large Caps	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. Recent China stimulus must translate to improve business and consumer sentiment before we will get constructive on the Resource sector.
Australian Equities – Small Caps	Slight Underweight	Supply-side focused stimulus measures in China are not likely to drive economic growth materially and, by extension, resume their appetite for Australian natural resources. This should disproportionately impact junior miners with make up a large portion of the Small Caps sector vs Large Caps.
Developed Market Equities – Large Caps	Overweight	The start of the interest rate easing cycle by major Developed Market Central Banks should be a tailwind for equities. We remove our preference for Europe as earnings and economic conditions have turned decided lower, and the conflict in Ukraine drags on.
Developed Market Equities – Small Caps	Neutral	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 preference for US over ex-US Small Caps.
Emerging Market Equities	Slight Underweight	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.
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	Private equity is now looking more appealing as the rates cut cycle commences. IPO and M&A activity has also improved providing better exit opportunities. 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	Slight Underweight	Our constructive view on risk and belief that the Reserve Bank of Australia will eventually lower its key policy rate next year sees us shift allocations to other parts of the portfolios.
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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