Lonsec

Portfolio Perspectives

Insights from the CIO Office

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Key Messages for Investors

- US long term interest rates are well above where they should be at this point in the cycle
- Three competing reasons for this anomaly lead to very different portfolio positions
- LIS believes all three reasons are interrelated, but the endpoint is not as alarming as the market currently expects
- While the current macroeconomic environment is solid, the first shots of a tariff war were fired on February 1, creating uncertainty and likely headwinds for global growth
- Trim some risk from portfolios

The US Government's 10-year (US10Y) bond yield is behaving oddly. Over the past 40 years, in virtually every instance when the US Federal Reserve (Fed) was cutting its key policy interest rate, long-term interest rates moved in lockstep lower with the reduction in short-term interest rates. It has now been nearly three months since the Fed first cut interest rates, and historically, the average decline in the US10Y yield would be 0.4%. Instead, the US10Y yield is 0.8% higher! This means while short-term borrowing costs are falling, long-term borrowing costs are rising, creating a headwind for anyone wanting to borrow long-term. There are three popular explanations for the anomaly.

The Classic Reason

In conventional economic theory, long-term interest rates are higher than short-term rates during periods of economic growth. This is because a strong economy usually leads to inflation, which means the central bank (in this case, the Fed) would be raising interest rates at some point in the future. Today's high long-term interest rate reflects the market's anticipation of higher interest rates in the future. Currently, the US economy exhibits solid growth at 2.5%. The services sector continues to expand, as seen in the Services PMI Index reading at 54.1, and even manufacturing is showing signs of recovery, with the Manufacturing PMI Index finally breaking just over 50, which is the key inflection point when the sector expands again. With the unemployment rate at 4.1% (still around multi-decade lows), real wage levels back to pre-COVID levels and households still spending, as seen in the good holiday retail sales figures, the US is undeniably in a period of economic growth. This fulfils the classic explanation for higher long-term interest rates.

Indicative Portfolio Action: Buy more growth assets as the outlook for the US economy is strong, suggesting corporate profits will also rise, supporting shareholder returns.

The Concerning Reason

Alternatively, US bond investors are becoming worried that President Trump's policy platform will push already high levels of deficit spending into the stratosphere. The US Congressional Budget Office (CBO, an independent, bipartisan group that reviews US government spending) continues to show that the debts of the US Government are on pace to exceed levels only ever achieved during World War II. With COVID behind us and the absence of a global conflict involving 70 nations, what crisis is the US government combatting? For context, US Government debt as a percentage of GDP peaked at 106% in 1946. The current spending path of the US Government is forecasted to reach and exceed that level by 2029 (four years from now). US bond investors are then said to demand higher interest payments, given the expected steady supply of new bonds needed to fund all this spending.

Indicative Portfolio Action: Sell Bonds as the growing supply of US bonds means investors will likely demand a higher yield (lower price) to keep encouraging them to buy more.

The Alarming Reason

If the US economy grows and government spending expands, this will surely bring on inflation. Even worse, inflation today at 2.8% is well above the Fed's target rate of 2%. If inflation gets out of control, the Fed will be forced to RAISE interest rates again, leading to headwinds for the economy and weaker capital market returns - perhaps even a crash, given how lofty US equity valuations are currently.

Indicative Portfolio Action: Sell Equities and Bonds and increase cash allocations as rising interest rates will hurt bond prices and equity valuations.

LIS believes all three reasons are interrelated, but the endpoint is not as alarming as the market currently expects.

We agree the US economy is in good health and was a key reason we added risk exposure back into our portfolios some months ago. We also agree that US debt levels will rise, and the government must curtail spending at some point. However, while inflation remains above target, services inflation is falling, and deficits as a percentage of GDP are forecast to decline, according to the CBO. While US debts are still rising, it is occurring at a decelerating rate - after averaging an annual increase of $2.2 trillion from 2020 to 2024; US debt growth should slow to $1.96 trillion and $1.9 trillion in 2025 and 2026, respectively. This means the stimulatory impact of deficit spending on the economy will ease in the coming years.

We believe that inflation will remain elevated, but not reach critical levels necessitating an increase from the Fed. This also means we are not expecting material interest rate cuts immediately either.

As long as the US economy and households remain healthy, slightly above-target inflation is manageable.

Then Along Came Tariffs

On 1 February 2025, President Trump announced various tariffs against Canada, Mexico and China. As we wrote in a previous note, the earlier rounds of tariffs under President Trump coincided with a 1.3% reduction in global GDP growth and a 7% decline in the broader stock market over 2018. Global GDP growth ended 2018 at 2.1% versus today's starting point, with global GDP growth around 1.3%. Global economic growth today is not as robust and the size of the proposed tariff package is significantly larger, so an extended period of tariffs could threaten recessionary-like conditions for many countries.

At the time of writing, Canada and Mexico have negotiated a one-month extension before the US will implement tariffs following concessions to boost border security. Markets have welcomed the deferral, but the parallels back to 2018 when tit-for-tat tariffs between China and the US and worsening market sentiment through the year, means investors must remain alert. The longevity of any tariffs is the real determinant on whether economic consequences will be manageable or severe.

It has become evident that President Trump will use the threat of tariffs aggressively. While President Trump may yet alter or even withdraw these latest tariffs, it is clear that we have less certainty about the future. Tariffs will have immediate and far-reaching negative economic impacts if left unaltered.

Outlook and Positioning

We are trimming our pro-risk portfolio stance as the threat of a protracted tariff war necessitates a more cautious approach. At worst, history already shows that protracted trade friction leads to economic contraction and inflation for most economies. We have seen estimates that show the US imposed tariffs are expected to increase US inflation by ~0.7% and this is before any potential retaliatory actions by trade partners. At best, heavy-handed policy implementations reduce risk appetites as investors lack the confidence to commit capital fully. With equity valuations already stretched and the Fed showing to be much more tentative with further interest rate cuts, we have trimmed our Dynamic Asset Allocation (DAA) positioning and instead rely more on our Strategic Asset Allocation (SAA) during this period of uncertainty. Overall, we move back to slightly Underweight Growth assets but maintain plenty of optionality throughout the portfolio.

We move our Developed Market (DM) Equities - Large Cap allocation from Overweight to Neutral. This reflects our decision to trim our pro-risk position. There are no winners from a global trade war. While the US may manage to tread water economically with additional support from proposed tax cuts likely, global growth faces headwinds with Europe, Canada, China and other emerging markets firmly in President Trump's sights.

We move our DM Equities - Small Cap allocation from Neutral to Slightly Underweight. We recognise that our SAA is slightly biased toward Small Caps in its construction versus the MSCI World. This Slight Underweight will help make our portfolio beta more aligned with the broader market.

We move our Australian Bonds allocation from Slightly Overweight to Overweight. Australia's relative fiscal position remains stronger than the US. We also believe that long-term interest rates in Australia represent good value at current levels.

We move our Diversified Income allocation from Slightly Underweight to Neutral. This reflects that inflation should remain sticky, reducing the pace of future central bank interest rate cuts.

We recognise that current macroeconomic conditions are generally solid but lack the conviction that they will persist with the first shots of a trade war already exchanged.

Regarding DeepSeek and the recent sharp sell-off in artificial intelligence-related stocks, our portfolios have generally been underweight in the Magnificent Seven and US technology for quite some time. As a result, our portfolios continue to trade well on both an absolute and relative basis. Our philosophy of always seeking diversification and managing downside risk meant we had moved to other market areas where we could find better risk/return opportunities. For example, over the past year, we made dynamic asset allocation decisions to US small caps, global real estate and reduce our exposure to Australia, which has benefitted our investors. Similarly, using high-quality active managers has also added value to investors. An active approach to portfolio management remains important during these volatile times.

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			●				

Current Position ● New Position ○

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 continue to support the economy. Inflation is receding, paving the way for Reserve Bank of Australia (RBA) cuts. While Australia does not yet appear to be in Trump's sights for tariffs owing to our trade surplus with the US, second order impacts (particularly in relation to China) cannot be ignored.
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. The prospect of an all-out trade war further complicate the outlook. This should disproportionately impact junior miners who make up a large portion of the Small Caps sector vs Large Caps.
Developed Market Equities – Large Caps	Neutral	With valuations already stretched and the US Federal Reserve more circumspect given the potential for higher inflation, we see a scenario where current tailwinds turn into headwinds as the year progresses should a global trade war escalate.
Developed Market Equities – Small Caps	Slight Underweight	With the US Federal Reserve likely to pause its easing cycle we have moderated our view on global small caps slightly. Valuations remain somewhat attractive and small companies tend to be more insulated and domestically focused, shielding them from the worst of a global trade war.
Emerging Market Equities	Slight Underweight	While valuations look attractive on a relative basis, the growth outlook for China in particular remains challenged. Recent China stimulus has not yet translated to improved business and consumer sentiment. With the prospect of tariffs also looming, some caution is warranted.
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	With key policy rates lower than this time last year, 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 with lower policy rate settings. 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	Overweight	Australian bond yields offer good value and provide safety from overseas volatility. Positive supply/demand dynamics in play with budget deficit likely to be less than government forecasts.
Global Bonds	Neutral	The size of the US fiscal deficit is a headwind given the need for funding, however safe-haven buying provides some support. Japan is still in hiking mode.
Diversified Income	Neutral	Floating rate public credit still offers relatively attractive yields as uncertainty remains around the timing of Reserve Bank of Australia (RBA) interest rate cuts.
Conservative Alternatives	Neutral	Gold acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.
Cash	Slight Underweight	Cash is a balancing item.