Lonsec Investment Solutions

Portfolio Perspectives

Insights from the CIO Office
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Key Messages for Investors

- President Trump continues to push his tariff agenda despite weakness in markets
- Policy uncertainty is driving very weak consumer and business expectations, leading to significant deterioration in the US growth outlook
- If President Trump does not change course soon, recessionary conditions could play out in many parts of the global economy. We move to Slightly Underweight Developed Market Equities
- We now see better opportunities in emerging markets where we see attractive valuations, and a clear policy shift to support consumption. We move back to Neutral in Emerging Market Equities

Tariffs are not fake news

Since February 1, President Trump's unwavering commitment to employ tariffs in order to fund proposed tax cuts has reverberated through global markets and economies. None more so than in his home country, where we observe some alarming trends.

Paraphrasing Tim Toohey from Yarra Capital, the road to recession has three paths: collapsing consumer sentiment, collapsing business expectations and widening credit spreads. Through this lens, the US is looking increasingly vulnerable.

US data deterioration is alarming

The latest consumer sentiment survey from the University of Michigan reveals an alarming deterioration in unemployment and business condition expectations for the next 12 months. We are now observing levels usually associated with prior recessions.

The speed of the decline in sentiment is breathtaking, and even more worrying, weakness is now also being reflected in the hard economic data, as seen in the GDPNow estimate from the Federal Reserve Bank of Atlanta (Atlanta Fed). Remembering that official GDP growth estimates are released with a delay, the Atlanta Fed takes real-time data to provide an estimate as new data becomes available. The model's historical accuracy is about +/-1.2% 30 days before the official data release, improving to about +/-0.7% seven days beforehand. We acknowledge that the model accuracy is only fair, but since January 29, the GDPNow estimate for 1Q 2025 GDP growth has fallen from 2.9% to -1.8%. Even allowing for a wide margin for error, the magnitude of the decline is cause for concern.

Trump's haphazard tariff announcements are feeding uncertainty both in the US and abroad, as seen in the Global Economic Policy Uncertainty Index, which recently exceeded levels seen during the early days of the Covid crisis. When policy uncertainty rises, businesses tend to delay or scale back investment decisions further impacting economic growth.

As we have noted previously, the scope of tariffs pursued by the Trump administration have the potential to push many parts of the global economy into recessionary conditions, however the severity of the slowdown will depend on the length and magnitude of the tariffs. Nevertheless, the risk of severe economic consequences emanating from a global tariff war is increasing.

The biggest country at risk of this war remains the US, given how interconnected its economy is in terms of global trade. However, such a dire outcome could still be avoidable if the tariff war ended quickly. Unfortunately, at the

time of writing, the direction of travel is worrisome.

As an aside, US high-yield credit spreads have moved slightly higher since the start of the year but remain well below alarming levels. Again, the direction of travel remains instructive.

The Case for Emerging Market Equities

Over the long term, emerging market (EM) equities have outperformed developed market (DM) equities as EM economies are boosted by faster population growth, urbanisation and rising productivity. However, over the last five years, EM has underperformed DM by 9.7% p.a. This was, in part, caused by China's economic slowdown and a strengthening US dollar. While some challenges remain, we believe the tide is turning and adopt a more favourable view on EM equities.

Chinese recovery is underway

China's economy has been grappling with significant structural challenges, including a troubled property sector, an aging population, and subdued consumer demand, all of which have weighed on growth. However, early signs of recovery are emerging, providing a potential tailwind for Chinese equities and the broader region.

The Chinese government has prioritised property market stabilisation in its 2025 agenda and has implemented various measures to reduce its excess housing inventory. While a strong rebound is unlikely, we believe China's real estate market has bottomed, with encouraging indicators such as increasing home sales volume and a recent uptick in new home prices.

Facing a declining labour force and diminishing returns on investment, China has committed to strategically integrating technological and industrial innovation to invigorate its economy. This commitment, reiterated during the recent National People's Congress with the goal of 'unleashing the creativity of the digital economy', is already evident in significant investments across the technology sector, including artificial intelligence (AI), semiconductors, and electric vehicles. Consequently, China is emerging as a genuine competitor to US technology dominance in cutting-edge areas such as AI with the release of DeepSeek. A rare public forum with technology leaders, including Alibaba founder Jack Ma, further underscores the government's focus on this shift, visibly signalling its ambition to position the country as a powerhouse of technological innovation. We view this as a key engine to boost productivity growth.

While the government has implemented several stimulative policies in the last few years, it has been largely focused on the supply side of the equation. This may provide some short-term reprieve, but ultimately, the root of China's lacklustre growth is weak domestic consumption. On March 16, 2025, China's State Council unveiled a plan to 'vigorously boost consumption' by increasing income and expanding domestic demand 'in all directions'. We see a shift towards demand-side policy solutions as an encouraging sign and a decisive step to revitalise consumer confidence.

Fading headwinds and emerging tailwinds

US Dollar (USD) peak

EM equities have historically exhibited an inverse relationship to the USD as a stronger dollar reduces capital inflows to EM markets and increases the cost of servicing USD-denominated debt for EM corporations and governments. The USD Index (DXY) has risen over 15% since the start of 2021, acting as a drag on EM equities. While future currency movements are highly uncertain, there is now more downside than upside risks to the dollar. Firstly, the US money supply is loosening, and the US Federal Reserve has begun its rate-cutting cycle, putting downward pressure on

yields and the currency. Secondly, President Trump has made clear his intentions to reduce the value of the USD against other currencies to make US exports more competitive in international markets. Given the dollar is elevated versus history and the mean-reverting nature of foreign exchange, a fall in the USD will be a boon for EM equities.

US tariffs impact on China may be milder the second time

Heightened US-Sino trade tensions are not going away, given the hawkish, US bipartisan stance toward China. However, the impact of the latest round of tariffs on the Chinese economy is unlikely to be as material. In an effort to reduce US dependence since the first trade war in 2018, China has strengthened its domestic supply chains and industrial policies, while also diversifying its trading partners. US demand now accounts for a smaller fraction of the country's economic output, with exports (as a percentage of GDP) to the US over 20% lower at 2.7%.

Evidence of China's shift to new markets can also be seen in Australia, where Chinese-manufactured cars made up 17% of the market in 2024 from virtually nothing 10 years ago. Capital Economics predicts that if the US imposes a 60% tariff on China, it will only detract 0.4% from GDP growth (recall China is targeting ~5% GDP growth). Furthermore, the impact of tariffs on EM equities as a sector is reduced with some US demand diverting to other EM countries such as Vietnam, Malaysia, and India.

Compelling valuations

EM equities have appeared inexpensive for some time, but it is crucial to assess valuations in the context of the broader economic backdrop which we believe is supportive.

Income levels in emerging markets are growing, alongside greater demand for consumer goods and services. As these economies expand, their role in global economic activity is increasingly significant. According to S&P Global, EM nations are projected to grow at an average annual rate of 4% over the next 10 years and contribute approximately 65% of global economic growth.

The transition to a multi-polar world is gradually reshaping global economic dynamics, shifting influence centred in the US toward rising powers such as China, India, and Brazil.

Investors are currently under-allocated to the region, with capital predominantly flowing into top-performing US tech stocks, which are seeing a slowdown in earnings growth.

In contrast, Chinese tech companies are experiencing an acceleration in earnings. Although there has been some rotation into these companies, they are still trading at a substantial discount compared to their US peers.

EM equities are projected to experience relatively stronger earnings growth than their developed market counterparts in 2025 and 2026, with consensus forecasting a 13% annual growth rate. The sector's valuation, as proxied by the forward price-to-earnings ratio, is significantly cheaper at 12x earnings compared to 19x earnings for the DM benchmark.

In short, valuations, although attractive, in and of itself are not relevant for a capital allocator. However, combined with promising earnings growth and a structural story that supports a re-rating, it is a compelling factor for the sector.

Preference for active management

Allocating to emerging market equities within a portfolio offers diversification benefits, as the

sector exhibits only a 14% long-term correlation with the developed market equities benchmark.

Another important consideration is whether to adopt a passive or active approach. Implementing a passive investment strategy in EM equities presents several nuances when compared to DM equities. Research has shown that index trackers tend to underperform the broader EM peer group, partly attributable to an inefficient benchmark that results in greater volatility and higher fees.

We prefer to gain exposure to this asset class by carefully selecting high-quality active managers who are agile and well-positioned to capitalise on market opportunities that arise.

Outlook and Positioning

US equities look increasingly vulnerable as President Trump's unwavering commitment to pursue tariffs is a growing economic headwind, especially for the US itself. Worsening sentiment and hard economic data could quickly rebound if a tariff war were suddenly averted, but the direction of travel causes us to continue to wind back risk in our portfolios. We move to Slightly Underweight DM Equities - Large Cap from Neutral.

While a global trade war is negative for global growth, a slowdown would not hurt all countries and regions equally. EM Equities are dominated by China, where a policy shift to support consumption and an economy that has recalibrated to be less dependent on the US since 2018 are supported by compelling valuations. We move EM Equities from Slightly Underweight to Neutral.

Cash is a balancing item that moves from Slightly Underweight to Neutral.

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 remain stretched and require a re-rating in bank and resource earnings. Earnings season was volatile and confirmed our view for a lacklustre growth outlook. Market growth expectations, in aggregate have been trending lower over the past year. 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	The prospect of an all-out trade war continues to 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	Slight Underweight	President Trump's unwavering commitment to pursue tariffs is a growing economic headwind, especially for the US itself. With valuations already stretched and the US Federal Reserve more circumspect given the potential for higher inflation, we see a scenario where headwinds increase as the year progresses should a global trade war escalate.
Developed Market Equities – Small Caps	Slight Underweight	Valuations remain somewhat attractive however with US companies forming 63% of the small cap index, a weaker growth outlook remains a key headwind for the sector.
Emerging Market Equities	Neutral	Emerging market equities are dominated by China, where a policy shift to support consumption and an economy that has recalibrated to be less dependent on the US since 2018 are supported by compelling valuations.
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.

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.
Conservative Alternatives	Neutral	Gold acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.
Cash	Neutral	Cash is a balancing item.