

Portfolio Perspectives

Insights from the CIO Office
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Key Messages for Investors

- Conflicts in Ukraine, Israel and Iran remain contained.
- “Hard” data for May is coming in and so far, indicates slowing growth but not an alarming deterioration of macroeconomic conditions.
- Equity markets are back to their highs on generally stretched valuations.
- Default risk (usually associated with rising recession risk) has abated as seen through the eyes of the high yield bond market.
- The “Big Beautiful Bill” is facing some Republican backlash keeping the “term premium” on US 10-year government bonds rangebound for now.
- Tariff uncertainty will remain, but the baseline becomes clearer as the worst-case scenario is seemingly off the table.
- We remain well diversified and slightly cautious in our positioning. We continue to monitor the hard data for confirmation of further deterioration (or improvement) from here.

Despite the increasing roar of bombs and warfare, markets have taken on an eerie calmness, standing in sharp contrast to the market turmoil witnessed following Trump’s Liberation Day tariff announcements. At Lonsec Investment Solutions, our thoughts always go first to those suffering in any conflict, and we advocate for a quick end to hostilities via peaceful means. For our investors, the national conflicts in Ukraine, Israel and Iran remain largely contained. While escalation that spreads beyond these defined geographies or that sees additional nations physically enter the battlefield would be a cause for alarm, at this time, we see no reason to change our portfolio positioning in response to these conflicts. We will continue to allow the diversification within our portfolios to manage most of the risk.

Update on macroeconomic data

Continuing our focus on “hard” economic data, we believe indicators from May onwards will begin to show the actual impact of the Trump Administration’s tariff policies. Recall that the first quarter macroeconomic figures for the US, in particular, were distorted by significant pull-forward trading as companies sought to import goods before tariffs came into effect. For context, US first-quarter imports rose by 42.6% on a quarter-over-quarter annualised rate, which is the highest reading in history outside of the pandemic. Data in the coming weeks will provide a clearer perspective on activity and behaviour as countries have come

to terms with some level of tariffs in their decision-making.

Part of our dynamic asset allocation process involves reflecting on the direction and level of various data sets, which we summarise via a heatmap. Conceptually, the greener the image, the stronger our conviction to add to Growth assets. This approach previously led us to add to Growth assets through 2024 as the image was “greening” across the board. However, for 2025, this trend has reversed, and a decidedly red hue is appearing across numerous indicators as May data comes in. Our heatmap has a decidedly US bias. Despite all the talk around the end of US exceptionalism, the US remains the world’s largest and most important economy for global growth. Even when we aggregate indicators across the Big 4 (the US, Europe, Japan, and China, which account for 64% of global GDP), the “reddening” is also apparent, with growth indicator levels declining.

Notably, the average of the Big 4’s Services Purchasing Managers Index reading of 50.2 at the end of May is only just above 50, the demarcation where activity is no longer growing but declining. Retail sales reflect this softening in the Services portion of the economy, where growth had previously been gradually accelerating through 2024 but has gone sideways so far in 2025. Recall that the Service sector, on average, makes up two-thirds of the economies of the Big 4, so it is

the major driver for their respective economies.

What we are concluding is growth, as expected, is slowing as a result of tariffs. However, the extent of the slowing is not yet alarming and thus far, appears orderly. An important consideration is that employment conditions remain robust, with the Big 4 (including Australia) experiencing multi-decade lows in unemployment. In the absence of a severe economic shock from extreme tariffs, which would likely lead to rapid job losses, we continue to believe that the worst of the possible tariff outcomes on economic growth are off the table.

What are the equity markets telling us?

Turning to corporate profits, it is also notable that the S&P 500 12-month forward earnings estimate has completely reversed the impact of the Liberation Day downgrades. The earnings estimate was \$277.53 on April 2. It got as low as \$275.20 and is now \$280.10. This reflects a natural upward bias in forward estimates, but it suggests that the market believes the impact of tariffs will be short-lived as long as they do not change materially from current levels. That said, the Price-to-Earnings ratio for the market is back to 21.8x, not far from its multi-year high, so expectations remain very bullish.

The Australian share market is in a similar situation. The Australian equity market rebounded strongly, with the S&P/ASX 200 index reaching record highs in early June. However, earnings strength did not drive this surge. We observed forward earnings growth expectations for the market were downgraded by 2.2% during this period, marking the third consecutive year of stagnant earnings growth on the ASX. Modest earnings growth expectations have driven the market's forward price-to-earnings ratio (19.1x) close to an all-time high, while the forward dividend yield of 3.3% currently sits at 20-year lows.

Commonwealth Bank's (CBA) fundamental-defying performance has significantly contributed to this valuation re-rating over the past 12 months. However, current market valuation levels are hard to justify, given the mediocre earnings growth outlook for the market over the next 12 months. Banks and

Resources dominate the market's earnings trajectory, and the outlook here remains challenged. The market expects Bank earnings to grow by a modest 2.8% in FY25, while the Resource sector projects earnings to fall 5.7% over calendar 2025.

In anticipation of further RBA rate cuts, we have also observed a significant re-rating in the "bond proxy" segment of the market this year, leading to lower projected dividend yields for many defensive names, such as Telstra and A-REITs, which are now tracking close to or below 10-year bond yields. This trend is also evident across the broader market, with the spread between bond and dividend yields turning positive, a phenomenon not seen in markets since 2011. Intuitively, the yield for bonds should be lower than shares because they carry less risk. The positive spread signifies extreme optimism for equity markets.

What is the bond market saying?

Even bond market sentiment, best reflected in High Yield spreads, has largely reversed back to pre-Liberation Day levels. The lower-quality parts of the bond market are typically where you can see the manifestation of negative sentiment, as investors usually sell down lower-quality assets first. This suggests the market believes the risk of default has abated.

Even the "term premium" on 10-year US Government Bonds has remained rangebound, as the Trump Administration's "Big Beautiful Bill" has yet to receive US Senate approval, with notable dissent within the Republican party on many elements of the bill. We have previously noted that the apparent poor fiscal discipline of the US government is driving bond investors to demand higher yields (as evidenced by the rising term premium) if US government spending plans do not exhibit restraint. Stabilisation in the term premium only adds to the general sense of calm stemming from a view that the most controversial policy choices by the Trump Administration will (again) get walked back.

Outlook and Positioning

Bond and Equity markets have largely brushed off the initial impacts of the Trump Administration's tariff policy and escalating geopolitical risks. The orderly slowdown in macroeconomic data so far might justify these muted reactions. However, the Trump Administration could easily disrupt this sea of calm with the drop of another radical policy announcement. This uncertainty continues to keep us slightly cautious in our positioning. We will continue to monitor the hard data for confirmation of further deterioration (or improvement) from here.

We maintain a slightly cautious outlook on global equities, given valuations are at stretched levels, and await confirmation on the direction of macroeconomic conditions. The potential for higher yields from the passage of the Big Beautiful Bill in its present form and/or higher tariffs would present headwinds for equities. Watch for 10-year yields above 5% as a key pain point for equity markets.

We reiterate our Overweight call on Australian Bonds, based on Australia's better relative fiscal position compared to the US. The US term premium can rise further unless policymakers enact budgetary discipline.

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 ●							

Growth Assets

Asset Class	Position	Rationale
Australian Equities – Large Caps	Neutral	Inflation is receding, paving the way for Reserve Bank of Australia (RBA) to continue cutting its key policy rate. Valuations are however back to stretched levels, and with only modest earnings growth expected from banks (and even less so from resources) for the remainder of the year we prefer a neutral positioning.
Australian Equities – Small Caps	Slight Underweight	The prospect of an all-out trade war has eased, but China remains firmly in the crosshairs. 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	Our outlook for the US economy has softened as Trump tries to balance tariff policy with fiscal tax cuts. We expect a softening in the US growth outlook but now consider a recession less likely. US valuations are extended and with bond yields rising, some caution is warranted.
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. EM will not be immune from weaker global growth resulting from tariffs however.
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.
Growth Alternatives	Neutral	Some improvement in the exit environment for private equity, however uncertainty around Trump's tariff policy is likely to weigh on public and private markets alike. Private credit is offering attractive yields, but spreads remain tight. Preference for global multi-strategy hedge funds that are liquid and can respond to rapid changes in macro conditions.

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 further supported by a budget deficit likely to be less than government forecasts.
Global Bonds	Slight Underweight	US fiscal and monetary policy uncertainty is distorting the defensive qualities of Global Bonds. 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. Ongoing support from Central Bank purchases.
Cash	Slight Overweight	Cash provides optionality during this volatile period.

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