Portfolio Perspectives

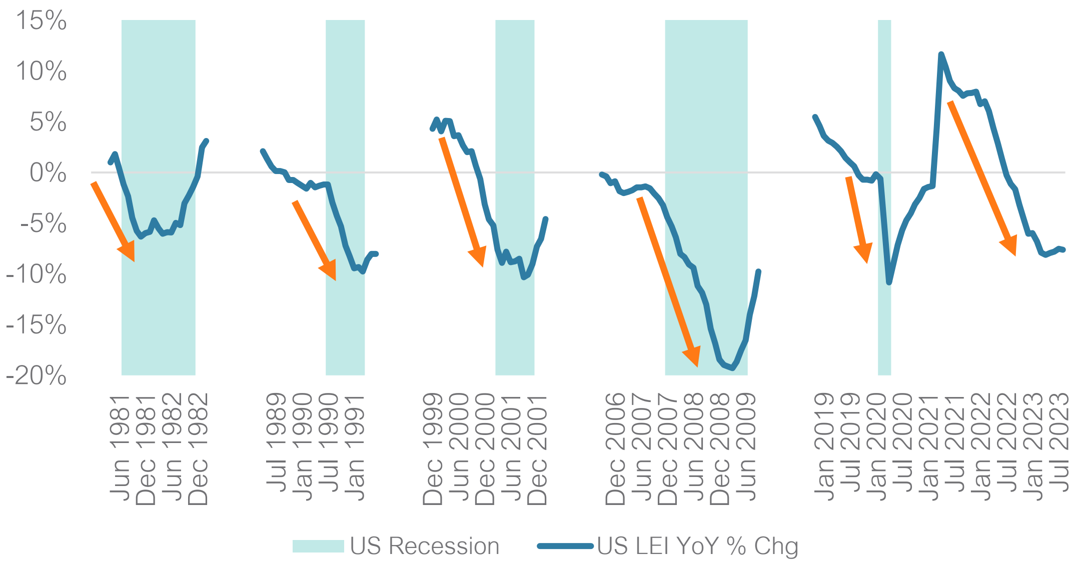
Insights from the CIO Office

November 2023

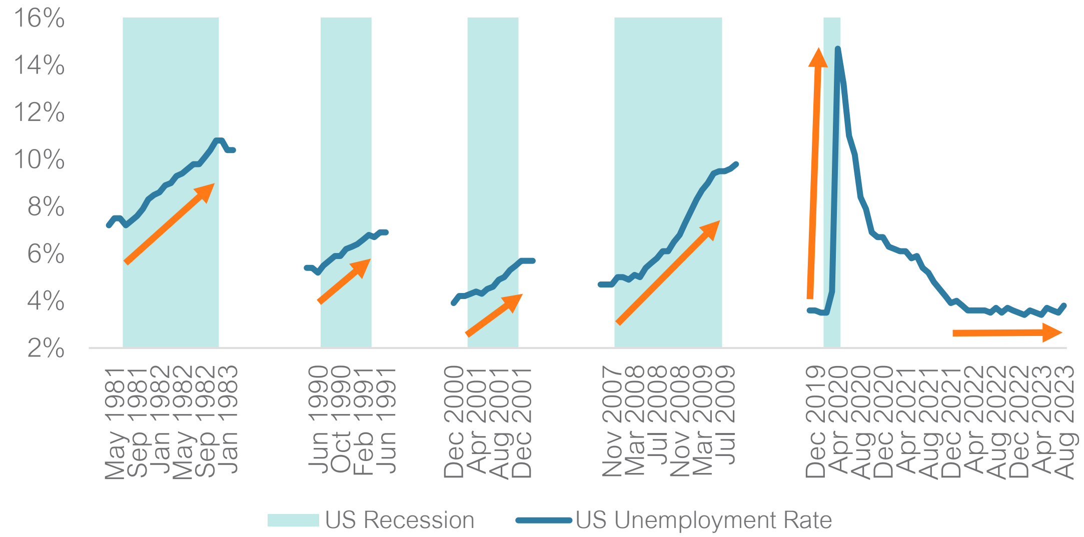
The beginning of the end (of this cycle)

The US Leading Economic Indicators (LEI) typically fall sharply before or at the beginning of recessions. US Unemployment rises steadily through the recession

The LEI has fallen sharply for the last 18 months



…but employment conditions remain robust



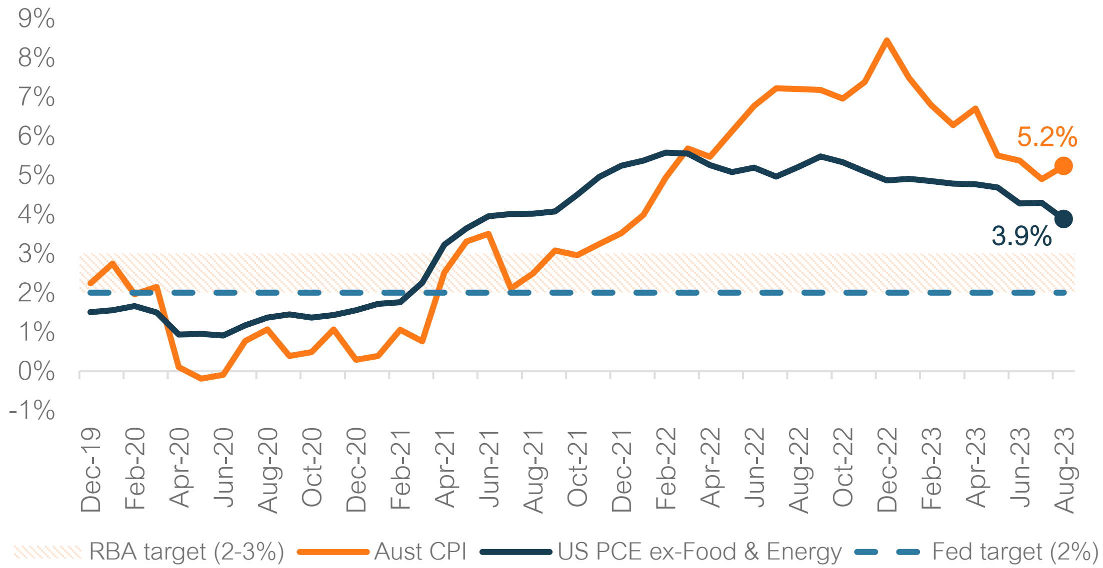
- The LEI is signally the beginning of the end of this cycle, but we have yet to get confirmation that the contraction phase has begun in the form of rising unemployment.
- US Recessions (peak to trough) since 1945 have been as short as two months or as long as 18 months but have averaged ten months.
- Too early to be outright bearish on markets: cautious but not bearish.

Source: ABS, FRED, NBER Lonsec estimates.

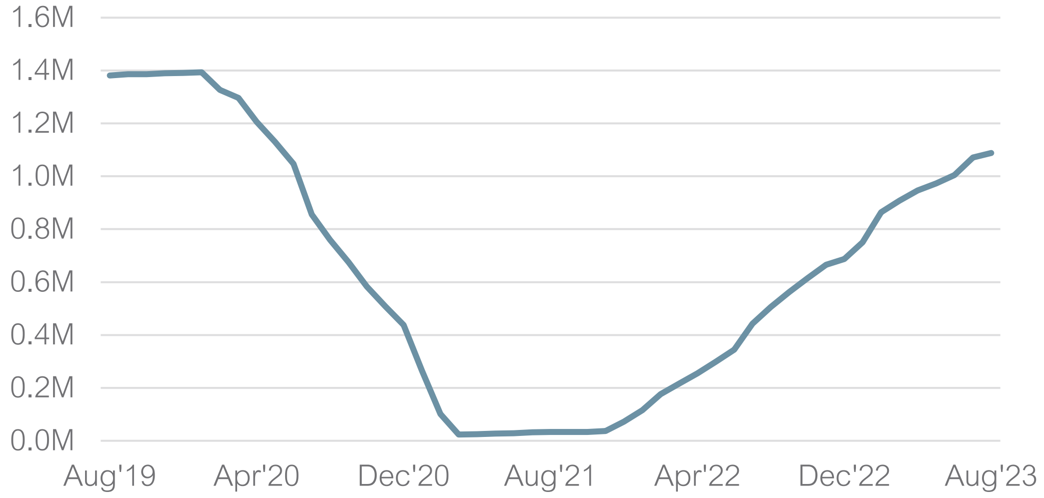
Interest rates will stay higher for longer

Inflation remains sticky and well above Central Bank targets because of drivers they don't control

Australia and US inflation remain well above target



Overseas Arrivals – Permanent Skilled Visas + Temporary Student Visas (Rolling 12-month total)



- Inflation remains well above target, preventing major Central Banks from considering lower interest rates.
- Some of the biggest drivers of inflation in Australia are rental prices, furniture prices and insurance premiums. None of these items are directly impacted by changing policy rates. This dynamic is occurring globally.
- For the 12 months to August 2023, 708,000 overseas students and 380,000 permanent skilled visa holders have entered Australia – a 4% increase to our population. The insurance sector has experienced catastrophe claims 75% higher in the last five years than in the previous five years.

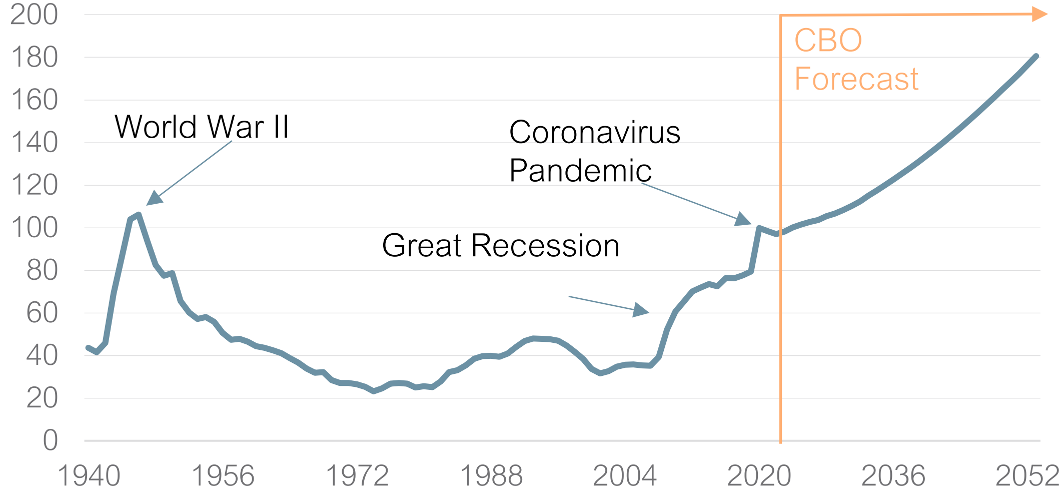
Source: ABS, FRED, RBA, US Federal Reserve, Lonsec estimates.

Fixed Income Market Observations

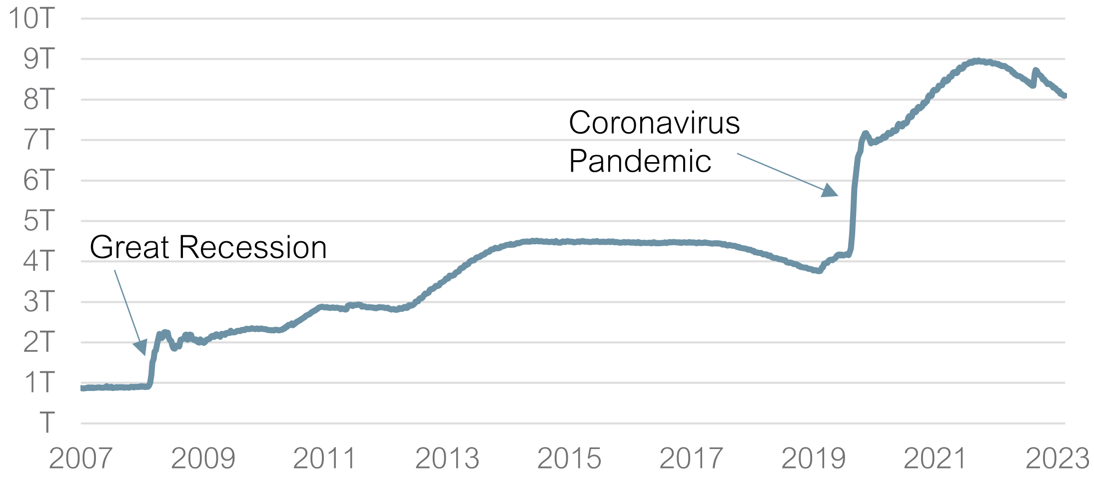
Lonsec

Where's the fire? The US government is spending like there is a crisis, what crisis are they fighting?

Federal Debt Held by the Public (% of GDP)



US Federal Reserve Balance Sheet (US$T)



The supply of US government debt is growing. The CBO projects the size of the US deficit to reach levels seen only during the WWII and the coronavirus pandemic. CBO forecast assumes the 2017 Trump tax cuts expire in 2025. Apollo* estimates 31% of ALL US debt must be refinanced in the next12 months.

The demand for US government debt from the biggest buyers might not be there. China and the US Federal Reserve are shrinking their holdings of US debt and Japan is dissuaded by high foreign exchange hedging costs.

Source: Congressional Budget Office – The 2023 Long-Term Budget Outlook, * https://apolloacademy.com/31-percent-of-all-us-government-debt-outstanding-matures-within-12-months/, US Federal Reserve, Recent Balance Sheet Trends, Lonsec estimates.

Equity Market Observations

US valuations remain unattractive, Australia to a lesser extent

US Equity Risk Premium (ERP) is 2-standard deviations from the mean

Australia's ERP just broke through 1-standard deviation

- The ERP is what Equity investors are paid for taking on the extra risk of investing in Equities over safer Bonds.
  - Example: How to calculate for Australia: ASX200 Earnings Yield (which is the inverse of the PE Ratio) *minus* the 10-Year Australian Government Bond Yield
- Even with the extremely poor ERP, the S&P500 is still up ~10% for 2023. The incredible performance of the Magnificent Seven makes the broad US market even less attractive in our minds.
- The broad backdrop of poor forecasted earnings growth and expensive valuations is not constructive for equities.

Source: Bloomberg, Lonsec estimates.

Outlook and Positioning

Lonsec

From here, watch what the new-look RBA does, the direction of employment conditions, and the continued orderly global macroeconomic deceleration

Growth Assets		Underweight		Neutral		Overweight	
Australian Equities				●			
Large Caps				●			
Small Caps				●			
Developed Market (DM) Equities			●				
Small Caps				●			
Emerging Market (EM) Equities				●			
Australian Listed Property				●			
Global Listed Property				●			
Global Listed Infrastructure			●				
Growth Alternatives				●			

Defensive Assets		Underweight		Neutral		Overweight	
Australian Bonds					●		
Global Bonds				●			
Diversified Income					●		
Conservative Alternatives				●			
Cash				●			

Growth Assets

- Mildly Underweight DM Equities given poor valuations.
- Mildly Underweight Listed Infrastructure as a higher for longer interest rates environment should continue to be a headwind for this sector.
- Within Growth Alternatives, we like Multi-Strategy Hedge Funds.

Defensive Assets

- Building duration back into portfolios with a preference for Australian long-term government debt.
- Building up the allocation to short duration/variable rate, investment grade debt to take advantage of attractive short-term interest rates.
- We keep an allocation to gold as a diversifier during these troubling times.