



Portfolio Perspectives

Insights from the CIO Office

February 2024

Key Messages for Investors

- Lonsec moves into the 'soft landing' camp
- The services economy is the key driver within most major economies and this portion of the global economy remains in expansionary conditions
- Consumer spending is constructive, fuelling the services economy
- Unemployment is near multi-decade lows representing a robust position to face any macroeconomic weakness
- Central banks are reducing the risk of a policy mistake by starting to talk about potential interest rate cuts
- Portfolios are being repositioned away from "Risk Control" in favour of "Market Exposure"
- Consider adding Global Small Caps to your portfolio

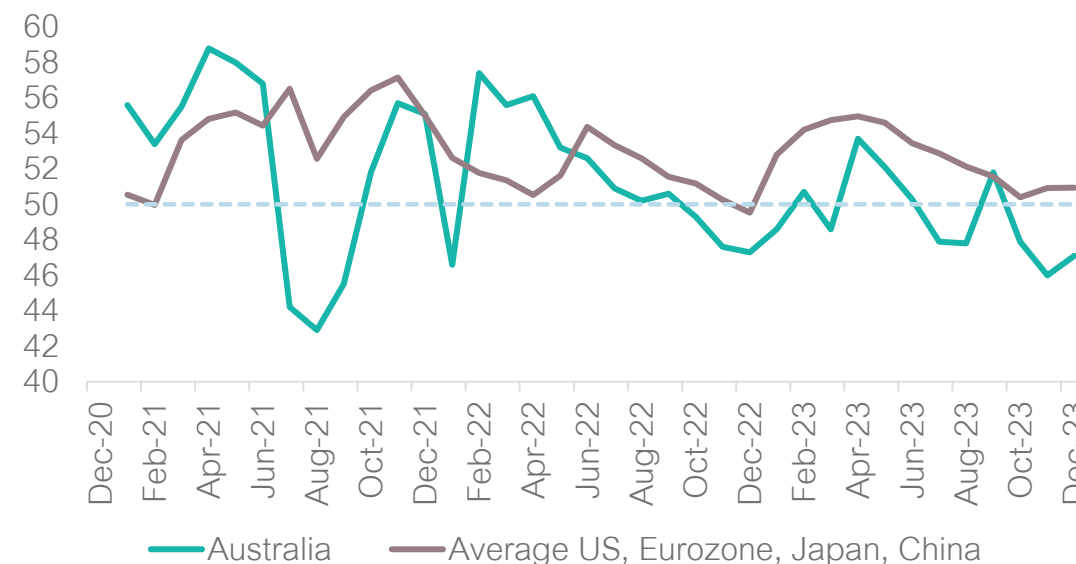
Focus on the Services portion of the economy

Services are the driver of the economy, not manufacturing

Services Economy % of GDP

| | % |
|-----------|------|
| US | 77.6 |
| Eurozone | 65.7 |
| Japan | 69.9 |
| China | 53.5 |
| Average | 66.7 |
| Australia | 65.7 |

Services Purchasing Managers Index (PMI)

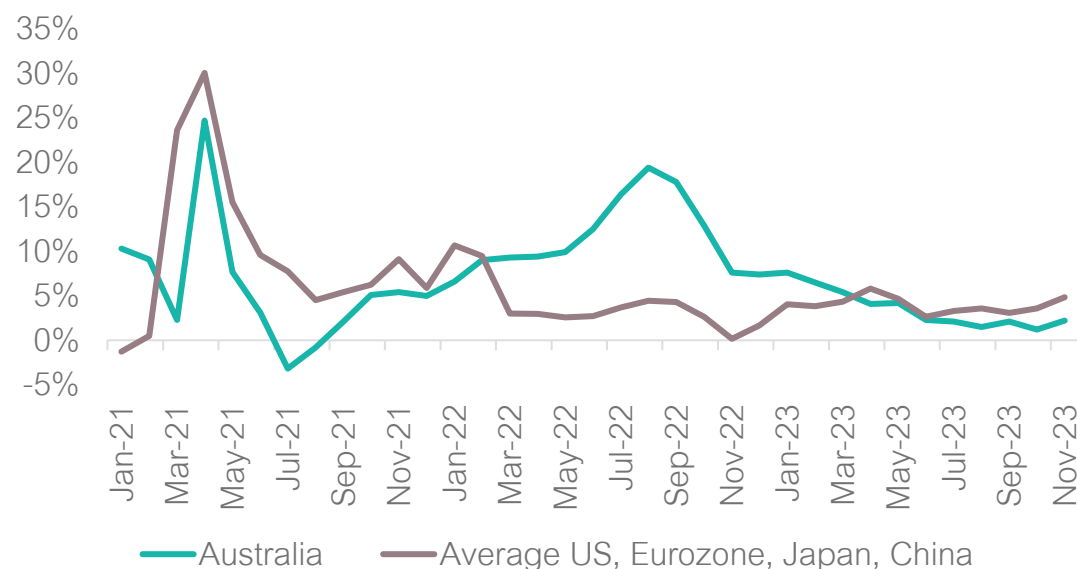


- Services represent the majority of economic activity in significant economies
- The US, Eurozone, Japan and China comprise 61% of global GDP. Within each economy, services (rather than manufacturing) represent the majority of economic activity. The US leads this measure at 78% of GDP, while China is 54%.
- The direction of the Services portion of the economy is pivotal for its outlook. A simple average of the Services Purchasing Managers Index (PMI) of the US, Eurozone, Japan and China remains above 50, the critical threshold demarking expansionary or contractionary conditions.
- This measure has only dipped below 50 once since at least 2021. While the average is only a modest 51, even a soft expansion in the services sector can underpin global growth.

Solid household spending and employment = Soft landing

Households are still spending and employment starting from a position of strength

Retail sales growth Year-over-Year



- Household spending for the US, Eurozone, Japan and China continues to grow, with retail sales averaging ~4% for much of 2023.
- Anecdotal comments from retailers and surveys also point to solid Christmas trading, suggesting an acceleration from the average into the end of the year. Consumer spending is fuelling the services economy, which is a cause for optimism

Unemployment Rates (%)

| | % |
|-----------|-----|
| US | 3.7 |
| Eurozone | 6.5 |
| Japan | 2.7 |
| China | 5.0 |
| Australia | 3.7 |

- Unemployment is at multi-decade lows, meaning labour markets remain tight. Said another way, it will take an extended period of job losses to bring labour markets to concerning levels.
- The Services PMI provides additional comfort because its employment sub-index in three groups remains above 50. However, the US was a notable exception, with the reading falling over 7 points in December to 43.3.
- To put the deterioration in the US into context, to get the US unemployment rate back to the long-term average of 5.7%, the US needs to add 3.2 million unemployed persons, all else equal. The US has added 2.4 million employed persons on average since 2009, excluding the Covid recession.

Notes: Unemployment Rates at December 2023 except Eurozone and Japan which are November 2023 Source: Bloomberg, Lonsec estimates.

Could the RBA raise rates?

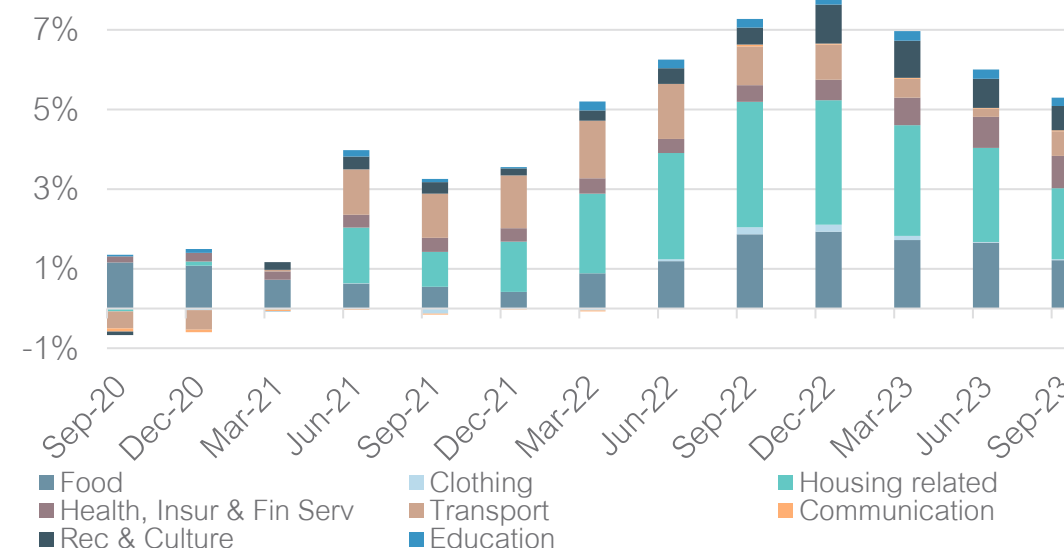
Australia already faces widespread inflation and Stage 3 tax cuts are coming

Estimated Impact of Stage 3 Tax Cuts on the Australian Economy

| Household | Tax benefit (monthly) | Consumption to Income Ratio | Annual Incremental consumption per household (\$) | Total Annual Incremental consumption (\$ millions) | Total Annual Incremental consumption % GDP |
|--------------|-----------------------|-----------------------------|---|--|--|
| 1st quintile | 35 | 111% | 424* | 675 | 0.03% |
| 2nd quintile | 111 | 86% | 1,143 | 1,818 | 0.08% |
| 3rd quintile | 200 | 82% | 1,970 | 3,133 | 0.13% |
| 4th quintile | 321 | 76% | 2,942 | 4,680 | 0.19% |
| 5th quintile | 388 | 61% | 2,860 | 4,549 | 0.19% |
| TOTAL | | | | 14,856 | 0.61% |

- Stage 3 tax cuts start from July 1
- How much of the tax benefit is potentially spent (vs saved) depends on the propensity to spend. We estimate how much household quintiles will spend using the latest household income statistics from the Australian Bureau of Statistics and the implied Consumption-to-Income ratio as a proxy for propensity to spend.
- The richest quintiles receive the greatest benefit this time (recall lower-income households were the focus of Stage 1 and 2 cuts).
- An estimated \$14.9 billion of the tax benefit could be spent in the first year of Stage 3 cuts, equal to 0.6% of GDP.

Contribution to Year-Over-Year Inflation Growth

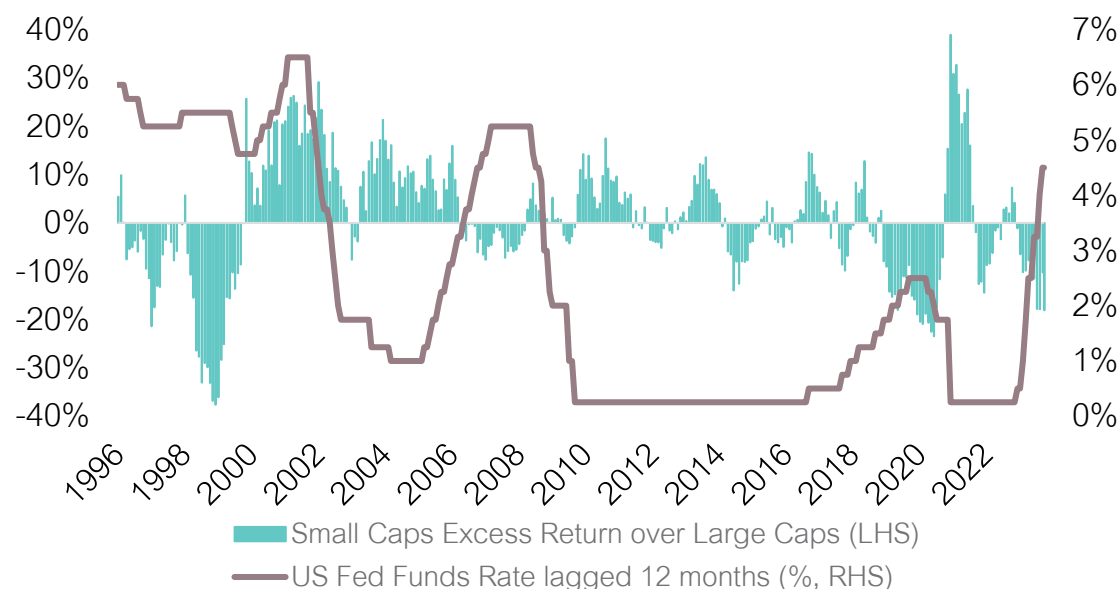


- With all underlying inflation groups still tracking higher, the potential surge in household spending could result in the Reserve Bank of Australia (RBA) raising interest rates in 2024.
- While our base case is for the RBA to remain on hold over the course of 2024, the upside risk to inflation is something we are watching keenly.

The Case for DM Small Caps

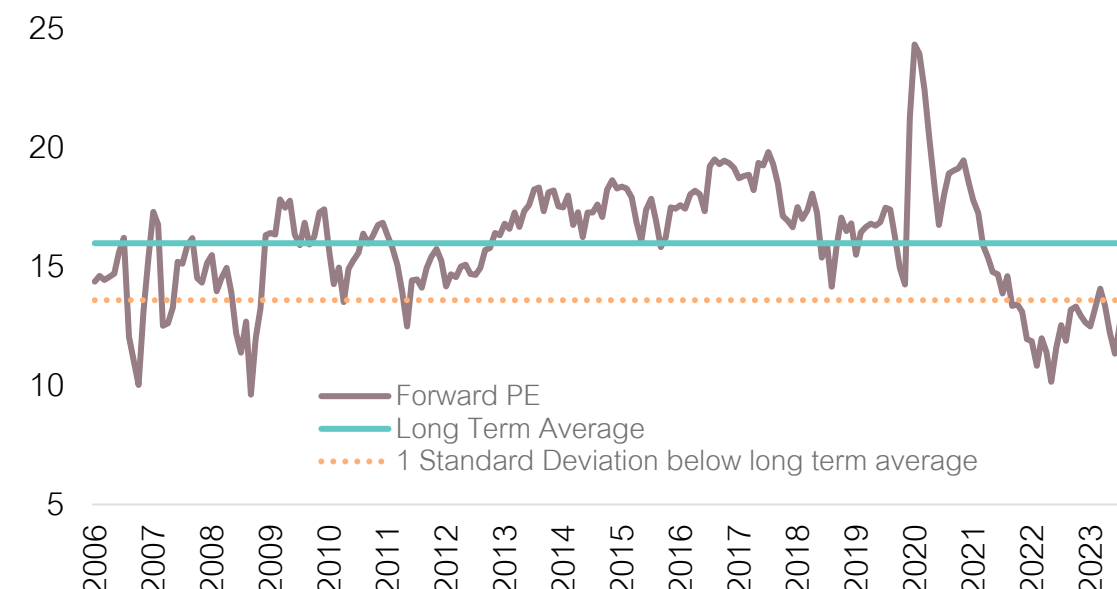
Lonsec moves to Slightly Overweight DM Small Caps in favour of DM Large Caps

US Small Caps excess Return Over Large Caps versus US Fed Fund



- Small Caps tend to outperform very early in the economic cycle, just before or as the economy shifts into expansion.
- In recent history, US Small Caps' outperformance started around the same time the Federal Reserve (Fed) cut its policy rate.

US Small Cap Forward Price/Earnings Ratio (PE)



- US Small Caps forward PE (13.2x) looks attractive from an absolute and historical perspective. US Small Caps also have stronger expected earnings growth than Large Caps (14% vs 11%)
- While DM Small Caps average forward PE looks cheap (13.5x vs long-term average 15.2x), given that US Small Caps make up over 60% of the index, this indicates that better valuation support is found in the US.
- Australian Small Caps are particularly expensive (17.5x forward PE vs long term average 15.1x).

Outlook and Positioning

Decreasing portfolios' "Risk Control" elements in favour of "Market Exposure". Central banks should begin the easing cycle but slower than expected because of persistent inflation. Moving to Neutral from Underweight Developed Market Equities. DM Small Caps moving to Slightly Overweight.

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

| Defensive Assets | Underweight | | Neutra | | Overweight | | |
|---------------------------|-------------|--|--------|---|------------|--|--|
| Australian Bonds | | | | | ● | | |
| Global Bonds | | | | ● | | | |
| Diversified Income | | | | ● | ● | | |
| Conservative Alternatives | | | | ● | | | |
| Cash | | | | ● | | | |

Current Position ● New Position ●

Growth Assets

- Soft landing expectations see portfolios decreasing allocations to "Risk Control" elements in favour of "Market Exposure". Moving to Equal Weight on DM Equities.
- DM Equities. DM Small Caps typically move ahead of the turn in the economic cycle, and US Small Caps, in particular, could move with the Fed starting its easing cycle. This leads to a Slight Overweight DM Small Caps at the expense of DM Large Caps with a preference for US over ex-US Small Caps.
- Global Listed Infrastructure. We see better risk/return opportunities in other asset classes for those seeking yield or capital appreciation.

Defensive Assets

- Australian Bond yields are now offering good value and bonds can once again play a defensive role in diversified portfolios. Focus on long-duration assets.
- Global Bonds. Supply/demand imbalances in the US treasury market remain a focus, reducing their relative preference versus Australian government bonds. The expected gradual unwinding of YCC policy in Japan should lead to an extended period of relative underperformance in Japanese Government Bonds.
- The potential start to an easing cycle reduces the relative attractiveness of floating rate yields. Moving Diversified Income to Neutral.
- We maintain an allocation to gold which acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.

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