



Portfolio Perspectives

Insights from the CIO Office

April 2024

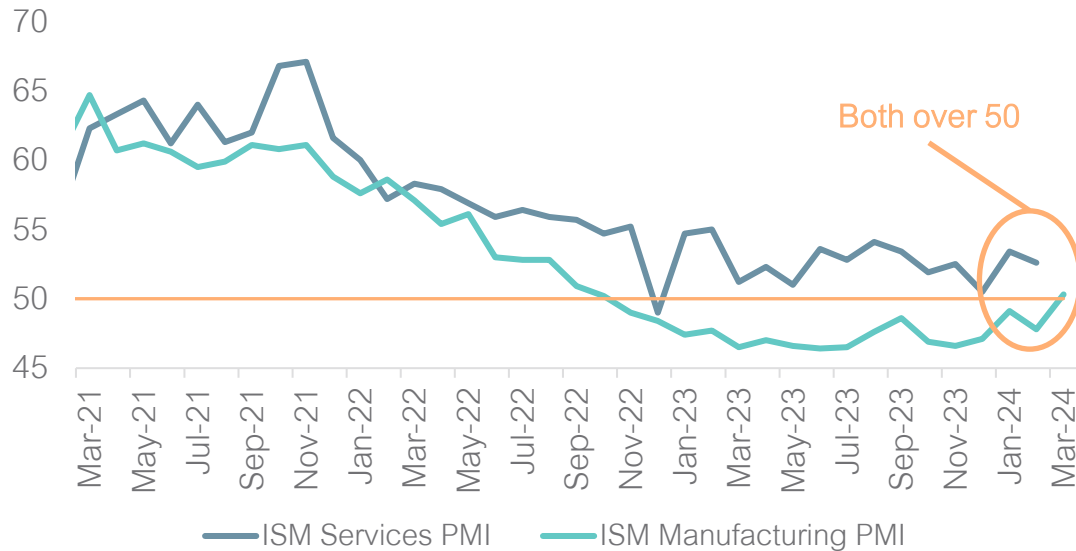
Key Messages for Investors

- Recent macroeconomic data supports our expectations for a "soft landing".
- The US yield curve has set a new record for the time inverted.
- Lonsec believes the inversion reflects more than a view that inflation will be sticky.
- We believe the market is becoming increasingly weary of the unsustainable fiscal path of the US deficit.
- US government interest payments on its debt are on pace to exceed spending on National Defence in 2024, becoming its third largest expenditure.
- The Australian government can demonstrate a pathway to lower absolute and relative debt levels.
- We believe the relative fiscal performance between nations should become a more prominent factor which keeps us overweight Australian government bonds versus the US.

Macroeconomic data supports Lonsec's “soft landing” view

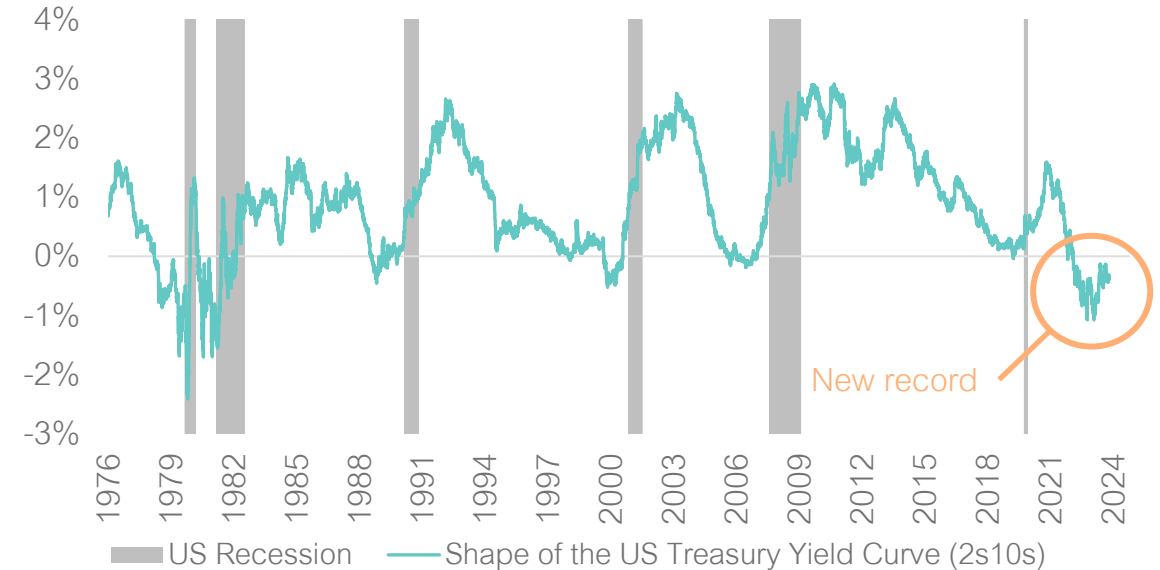
However, the US Yield Curve continues to signal a recession

US Manufacturing and Services PMI



- For the first time since September 2022, both the US Manufacturing and Services PMIs are over 50, the key demarcation between expanding and contracting activity.
- Recession risk is falling.

Shape of the US Treasury Yield – Negative values correspond to periods of yield curve inversion



- An inverted yield curve has preceded every US recession since 1955, except in the mid-1960s when the inversion preceded only an economic slowdown but no recession.
- The current inverted yield curve has broken the previous length of time record of 622 days.
- If a recession is now less likely, why is the curve still inverted?

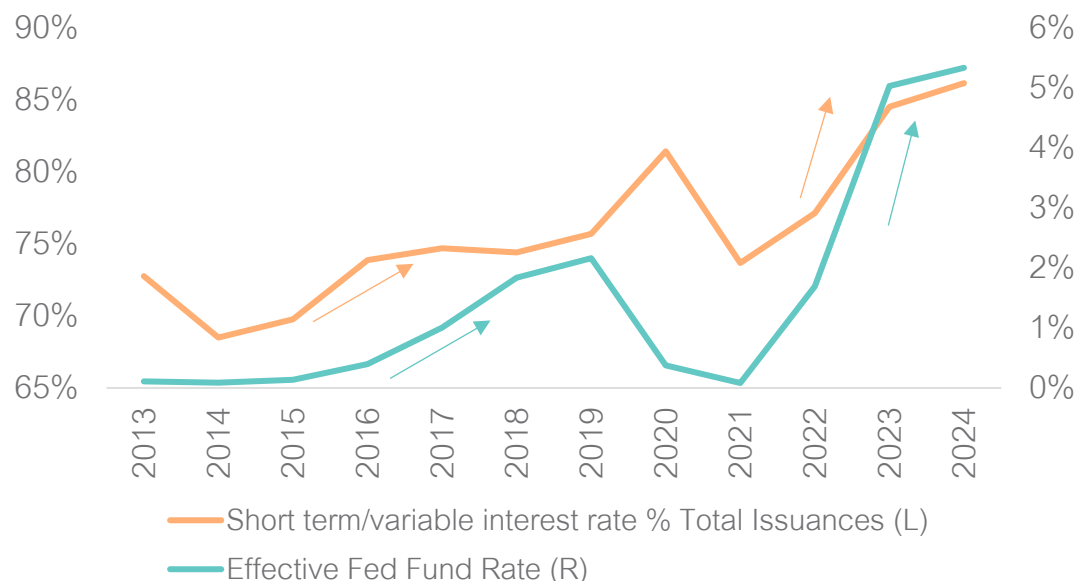
The shape of the US yield curve is telling

Inversion is caused by a market preference for short-term maturities over longer-term maturities

The market tends to prefer short-term, variable rate securities when the Fed is raising interest rates

US Federal Reserve (Fed) pivoted at their December meeting

Fed's expected number of 0.25% interest rate cuts in 2024



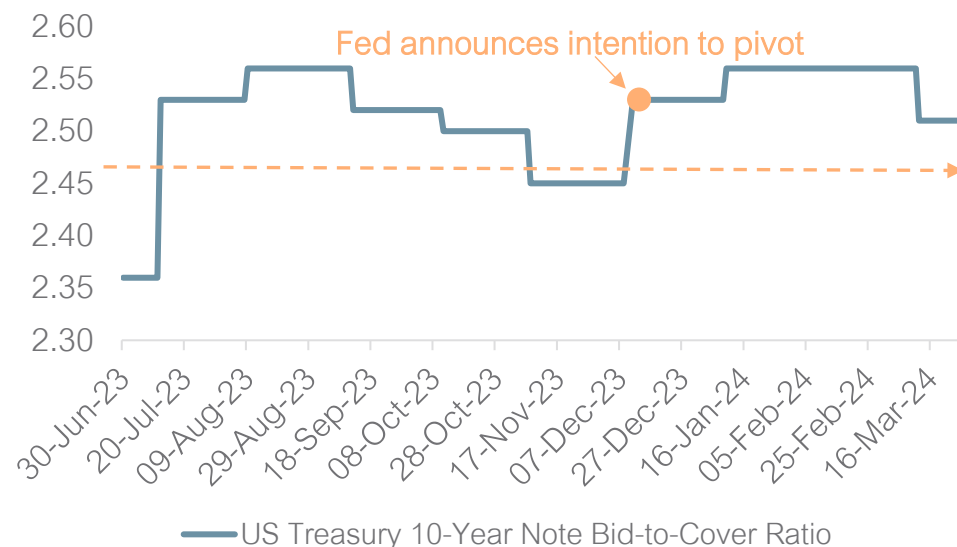
3

- We believe the US Treasury issues new debt to match the market's natural tendency to prefer variable interest rate securities over fixed rates when the Fed is raising interest rates.
- This is because short-term Treasury securities have a floating rate. Thus, the interest it pays will increase as the Fed raises rates. Recall that long-term Treasury securities have a fixed rate, which means rising interest rates result in the security's principal value falling.
- If the market believes the Fed is raising interest rates, the preference will be for short-term treasury securities.
- Back in December 2023, the Fed told the market it was going to cut interest rates, so why has this preference for short-term treasuries (manifested as an inverted yield curve) continued to persist?

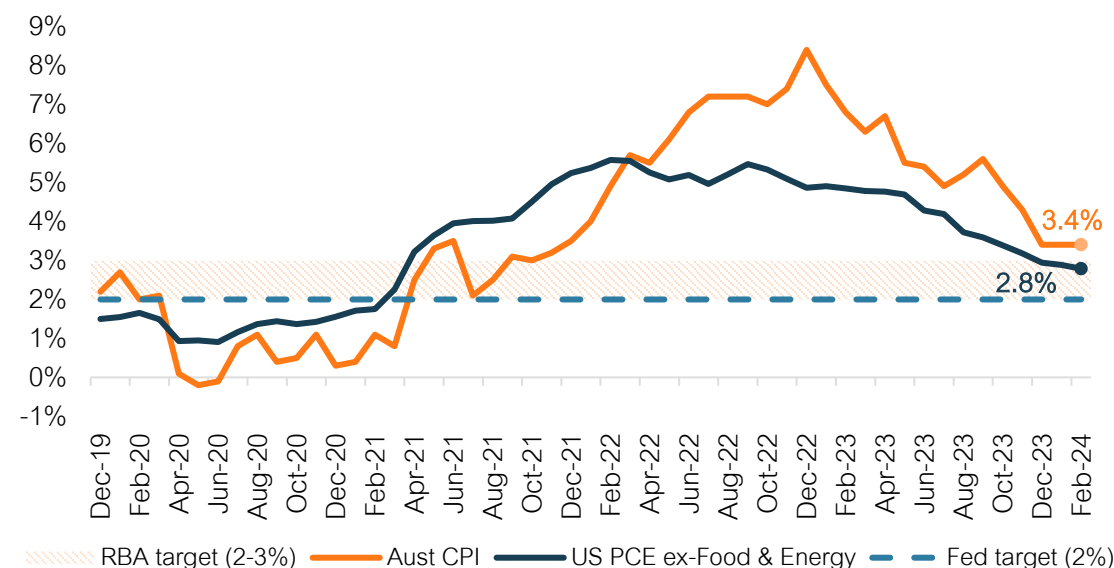
Preference for short term securities persists

The Fed pivot should have increased demand for longer-dated debt securities

US Treasury Auction – Bid-to-Cover Ratio



Inflation is sticky



- The bid-to-cover ratio is an indicator of the strength of demand for Treasury securities. With the Fed signalling its intention to reduce interest rates, demand for longer-term securities should be rising.
- All else equal a 0.75% reduction in the Fed's key policy rate would provide a ~6% lift to the principal value of the bond. Plus the coupon payments, the annualised total return of holding a 10-year bond today is around ~10%
- 10% total return on US treasuries has historically been very attractive

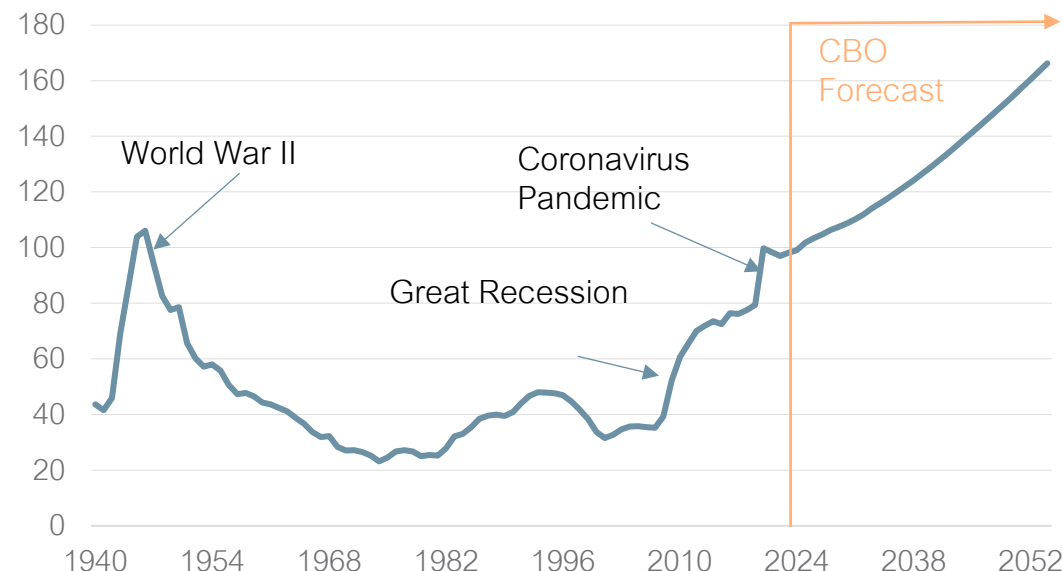
Source: Bloomberg, Lonsec estimates.

- The US Core Personal Consumption Expenditure (the key inflation measure monitored by the Fed) recently came in at 2.8%, still well above the Fed's 2% target. Notably, the sub-segment measuring consumer spending rose 0.8% in the month, well ahead of consensus estimates for a 0.5% rise.
- This highlights our concern that inflation, while decelerating, is sticky and will take longer to normalise. This view extends to Australia, where inflation is still running just under 4% as wages and rents continue to grow near mid-single-digit levels.
- The persistence of inflation is a factor many markets are grappling with.

We believe there is growing unease with US deficits

There is currently no plan to curtail US deficit growth by either major party

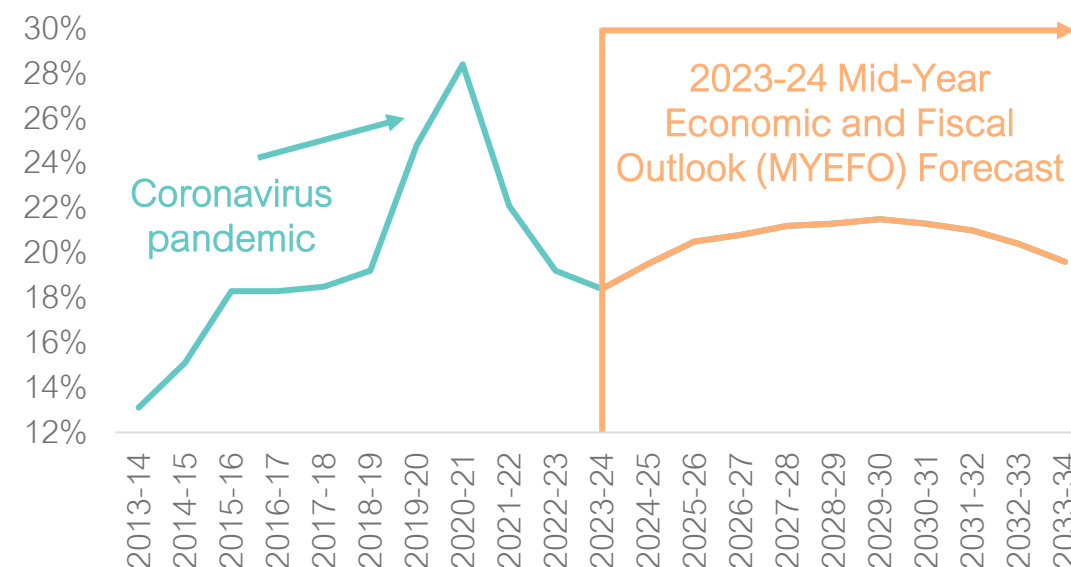
Total US Federal debt held by the public



- Inflation concerns may be supporting demand for shorter-dated debt securities. However, we think the more significant driver is likely the market's growing discomfort with the US government's fiscal path.
- The Congressional Budget Office (CBO) indicates the projected size of the deficit has only been at such levels during WWII and the coronavirus pandemic.
- In the absence of an existential threat like a global war or a pandemic, we are concerned the market is shying away from supporting US budgetary choices.

Source: CBO, Australian Government, Lonsec estimates.

Australia net debt % of GDP



- Interest payments by the US government are on pace to become the third largest spending category (surpassing National Defence) in 2024
- Australia is reducing its supply of new debt securities as it is poised to achieve another budget surplus in FY24.
- Unlike the US, the Australian government can demonstrate a pathway to lower absolute and relative debt levels. We believe the relative fiscal performance between nations should become a more prominent factor when deciding on bond allocations in the fullness of time, which keeps us overweight Australian government bonds versus the US.

Outlook and Positioning

We remain in the “soft landing” camp. Central Banks should be cutting interest rates, but sticky inflation will temper the pace. Prefer DM Small Caps

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

Growth Assets

- 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 end 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.
- We maintain an allocation to gold which acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.

Important Notice: This document is published by Lonsec Investment Solutions Pty Ltd (LIS) ACN: 608 837 583, a corporate authorised representative (CAR number: 1236821) of Lonsec Research Pty Ltd ABN: 11 151 658 561 AFSL: 421 445 (Lonsec Research). LIS and Lonsec Research are owned by Lonsec Holdings Pty Ltd ACN: 151 235 406. LIS creates the model portfolios it distributes using the investment research provided by Lonsec Research but has not had any involvement in the investment research process for Lonsec Research. Please read the following before making any investment decision about any financial product mentioned in this document.

Disclosure at the date of publication: Lonsec Research receives a fee from the relevant fund managers or product issuers for researching financial products (using objective criteria) which may be referred to in this document. Lonsec Research may also receive a fee from the fund manager or product issuer (s) for subscribing to research content and other Lonsec Research services. LIS receives fees for providing investment consulting advice, approved product lists, model portfolios to financial services professionals and other advice to clients. LIS' and Lonsec Research's fees are not linked to the financial product rating(s) outcome or the inclusion of the financial product(s) in model portfolios. LIS, Lonsec Research and/or their associates may hold any financial product(s) referred to in this document, but details of these holdings are not known to the analyst(s).

Warnings: Past performance is not a reliable indicator of future performance. Any express or implied rating or advice presented in this document is limited to "general advice" (as defined in the Corporations Act 2001 (Cth)) and based solely on consideration of the investment merits of the financial product(s) alone, without taking into account the investment objectives, financial situation and particular needs ("financial circumstances") of any particular person. Before making an investment decision based on the rating or advice, the reader must consider whether it is personally appropriate in light of their financial circumstances or should seek independent financial advice on its appropriateness. If the advice relates to the acquisition or possible acquisition of a particular financial product, the reader should obtain and consider the Investment Statement or the Product Disclosure Statement for each financial product before making any decision about whether to acquire the financial product.

Disclaimer: LIS provides this document for the exclusive use of its clients. It is not intended for use by a retail client or a member of the public and should not be used or relied upon by any other person. No representation, warranty or undertaking is given or made in relation to the accuracy or completeness of the information presented in this document, which is drawn from public information not verified by LIS. Financial conclusions, ratings and advice are given on reasonable grounds held at the time of completion (refer to the date of this document) but subject to change without notice. LIS assumes no obligation to update this document following publication. Except for any liability which cannot be excluded, LIS and Lonsec, their directors, officers, employees and agents disclaim all liability for any error or inaccuracy in, misstatement or omission from, this document or any loss or damage suffered by the reader or any other person as a consequence of relying upon it.

This report is subject to copyright of LIS. Except for the temporary copy held in a computer's cache and a single permanent copy for your personal reference or other than as permitted under the Copyright Act 1968 (Cth), no part of this report may, in any form or by any means (electronic, mechanical, micro-copying, photocopying, recording or otherwise), be reproduced, stored or transmitted without the prior written permission of LIS. This document may also contain third party supplied material that is subject to copyright. Any such material is the intellectual property of that third party or its content providers. The same restrictions applying above to LIS copyrighted material, applies to such third-party content.

Copyright © 2024 Lonsec Investment Solutions Pty Ltd