Lonsec

Portfolio Perspectives

Insights from the CIO Office

April 2024

Key Messages for Investors

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- 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

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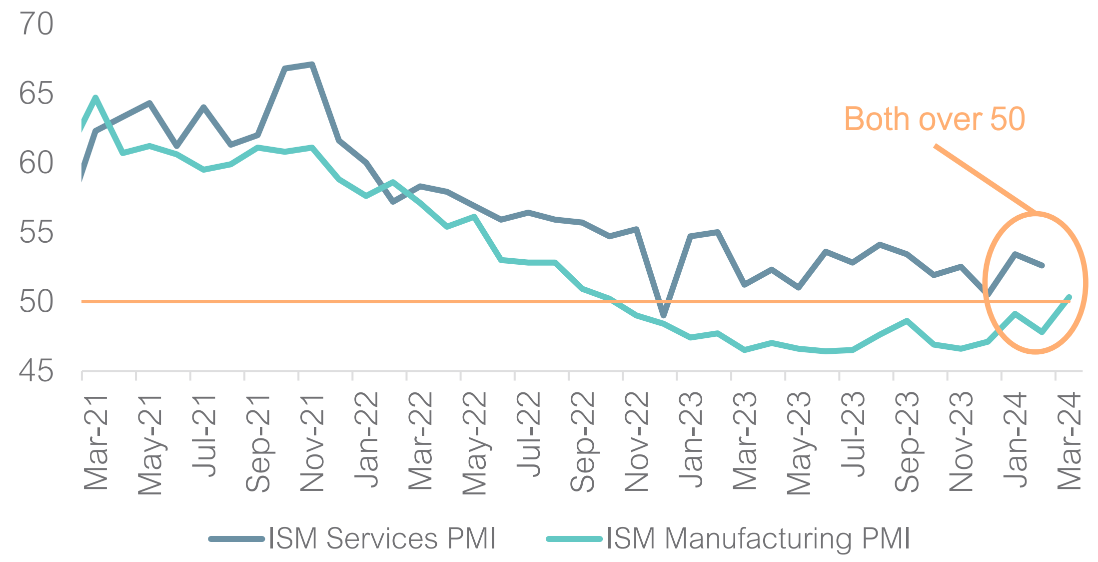
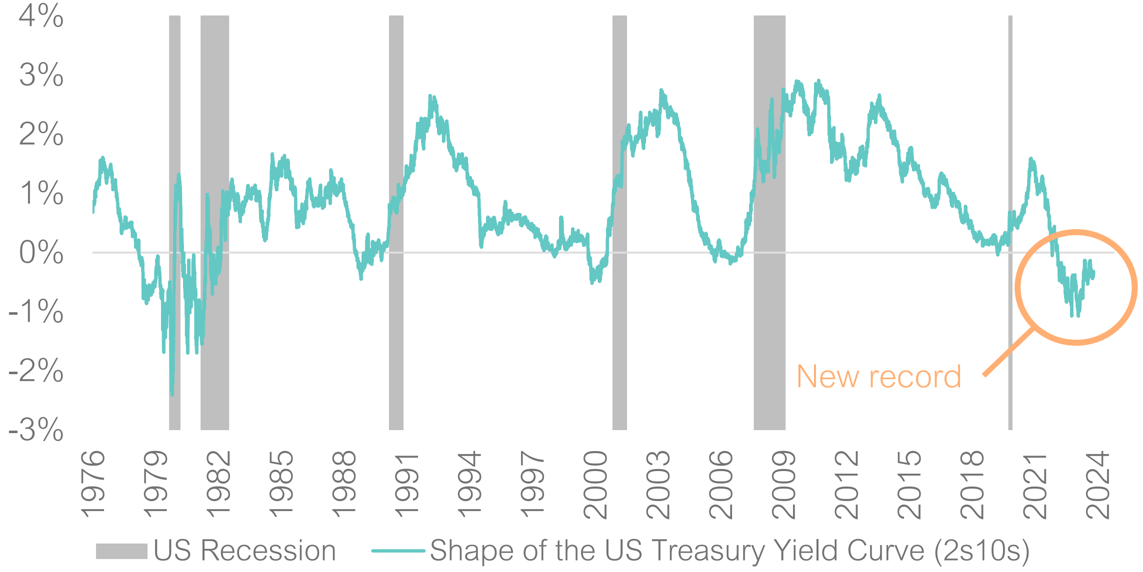
However, the US Yield Curve continues to signal a recession

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



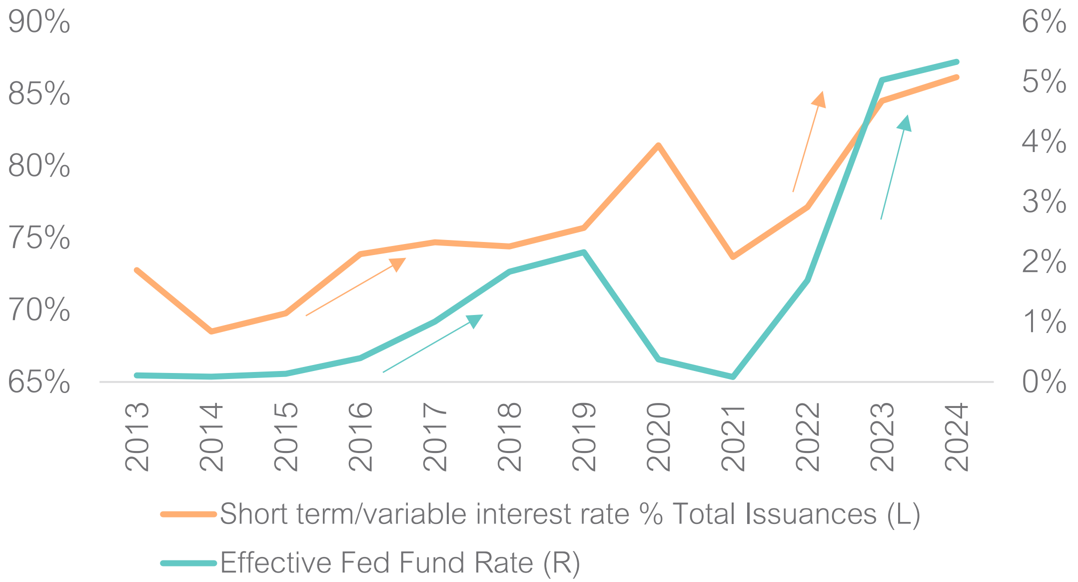
- An inverted yield curve has preceded every US recession since 1955, except in the mid-1960s when the inversion preceded only an economic slowdown but no recession.
- The current inverted yield curve has broken the previous length of time record of 622 days.
- If a recession is now less likely, why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

Source: FRED, BEA, US Federal Reserve, Bloomberg, Lonsec estimates.

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



- 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.

US Federal Reserve (Fed) pivoted at their December meeting

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

3

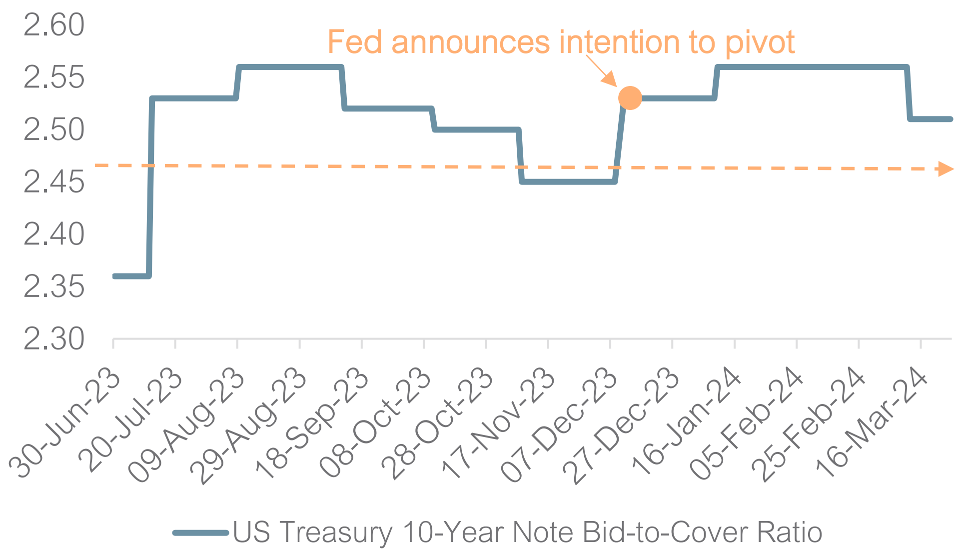
- Back in December 2023, the Fed told the market it was going to cut interest rates, so why has this preference for short-term treasuries (manifested as an inverted yield curve) continued to persist?

Source: FRED, BEA, US Federal Reserve, Lonsec estimates.

Preference for short term securities persists

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

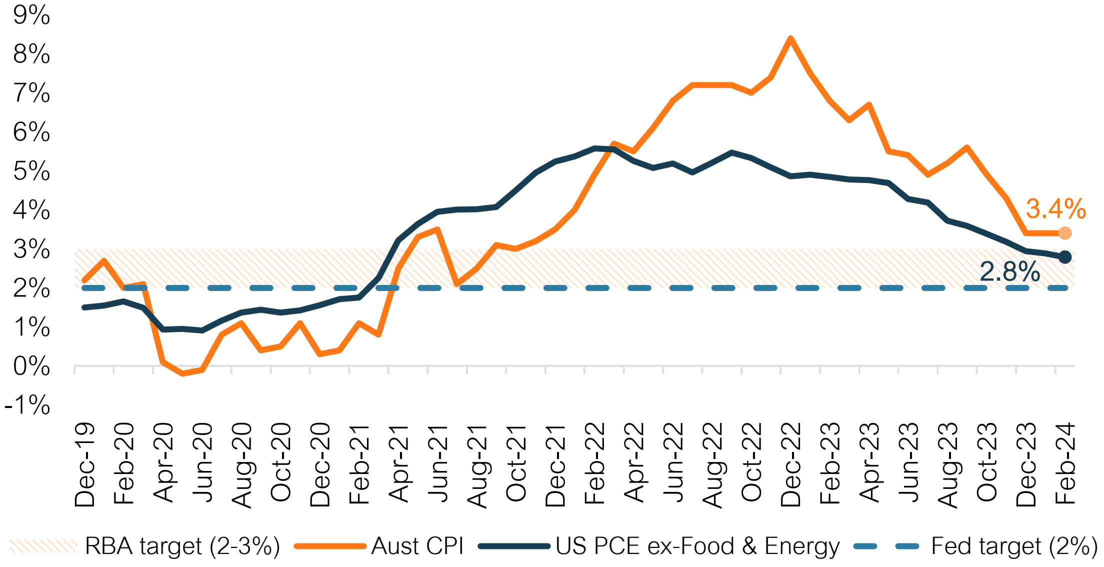
US Treasury Auction – Bid-to-Cover Ratio



- 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.

Inflation is sticky

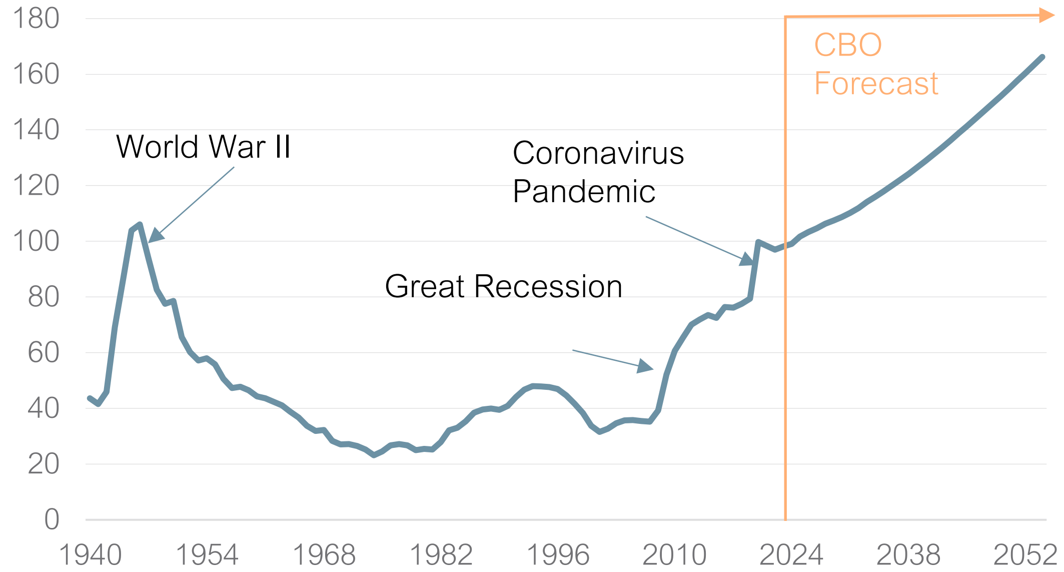


- The US Core Personal Consumption Expenditure (the key inflation measure monitored by the Fed) recently came in at 2.8%, still well above the Fed's 2% target. Notably, the sub-segment measuring consumer spending rose 0.8% in the month, well ahead of consensus estimates for a 0.5% rise.
- This highlights 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.

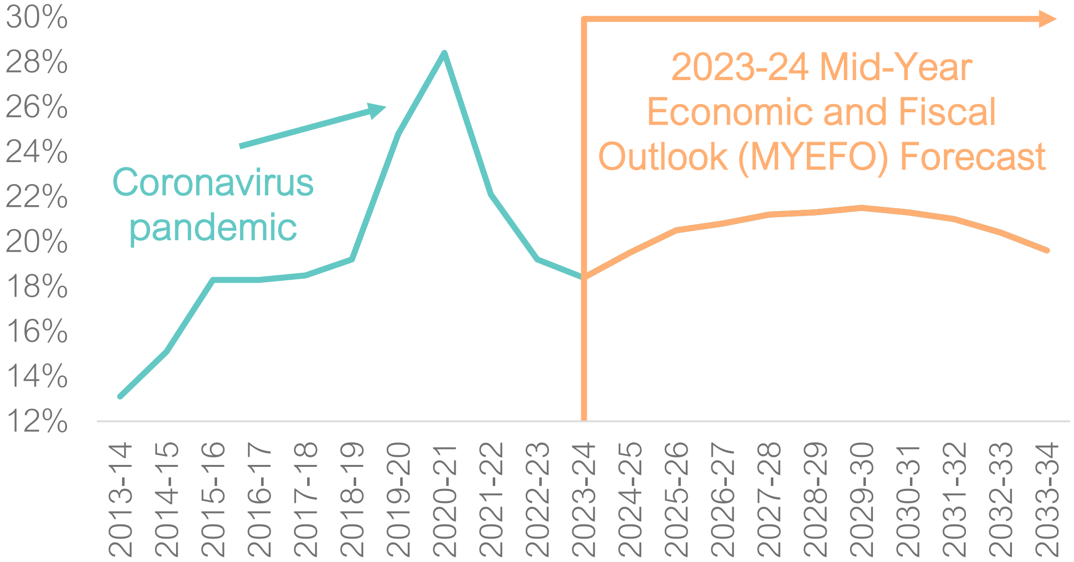
We believe there is growing unease with US deficits

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

Total US Federal debt held by the public



Australia net debt % of GDP



- 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.

- 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

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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.

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