MUTUAL TRUST

Quarterly Outlook

Parting clouds: cautiously optimistic

> "The U.S. economy is in very good shape and there's no reason for that not to continue ...the downside risks appear to be less in the labour market, growth is definitely stronger than we thought, and inflation has come in a little higher."
>
> JEROME POWELL, U.S. FEDERAL RESERVE CHAIR, DECEMBER 2024

In summary

As we move into 2025, markets are buoyed by renewed risk appetite and positive momentum. The uncertainty of major global elections is now resolved and attention has shifted to the implications of U.S. policies under President-elect Donald Trump. These policies, if implemented, are expected to reverberate through the global economy in various ways.

Navigating this landscape requires a careful balancing act as monetary, fiscal, trade and other policies are all simultaneously in flux. Until there is further clarity around policy developments, we continue to focus on underlying trends in economic fundamentals, which have improved over the past quarter. The probability of an impending U.S. recession has dissipated: consumer sentiment has improved, labour markets have rebalanced and recent manufacturing data has been revised higher.

In the near-term, the U.S. economy should benefit from stimulatory fiscal policy, while monetary policy easing is also underway. However, we anticipate the market will remain highly sensitive to disappointing data, earnings misses or unexpected policy changes shifting the economic outlook.

Therefore, as we head into 2025 and invest amid major policy shifts, we are cautiously optimistic:

- **Policy tailwinds are supportive for equities near-term,** despite high valuations. As U.S. recession risk decreased, we closed our small underweight to developed market international equities, favouring U.S. exposure, while remaining underweight Europe.
- **We remain moderately underweight Australian equities** due to sluggish economic growth, leverage to the decelerating Chinese economy and weak earnings growth from major sectors of the ASX 200 Index – resources and banks – for 2025.
- **Within fixed interest, we prefer Australian to international exposure** as we expect domestic yields to remain higher and more attractive, with a preference for credit over government bonds.
- **We continue to add exposure to alternative asset classes**, with a portfolio weighting as high as 30% to 40%, sourcing attractive investments across select private credit, private markets equity and opportunistic transactions in direct property.

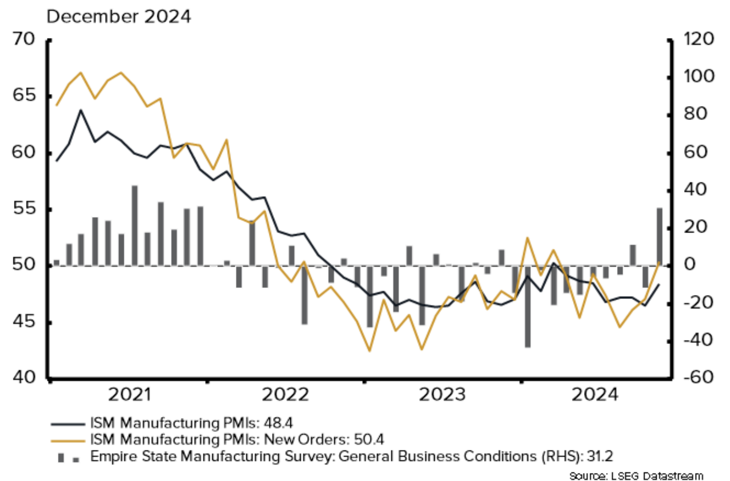
In our latest Quarterly Outlook, we explore changes over the quarter supporting our more optimistic outlook, reasons for some caution and our asset class views.

The U.S. outlook has shifted – our more optimistic view

Given continued U.S. economic exceptionalism and the challenges faced by other global economies, we currently favour U.S. equities, including small to mid-caps companies, while remaining highly selective with exposure to other regions.

Risk of U.S. recession has dissipated

Our outlook has shifted over the quarter. While U.S. GDP growth is expected to moderate in 2025, the risk of a near-term U.S. recession has fallen. Unlike other developed market nations, U.S. industrial activity is showing initial signs of a turnaround (as measured by manufacturing PMIs), and the New Orders subindex for manufacturing moved into expansionary territory in November after several months of contraction. Regional manufacturing surveys also saw a material pick up in November. Meanwhile, the services sector in the U.S. remains in expansionary territory.



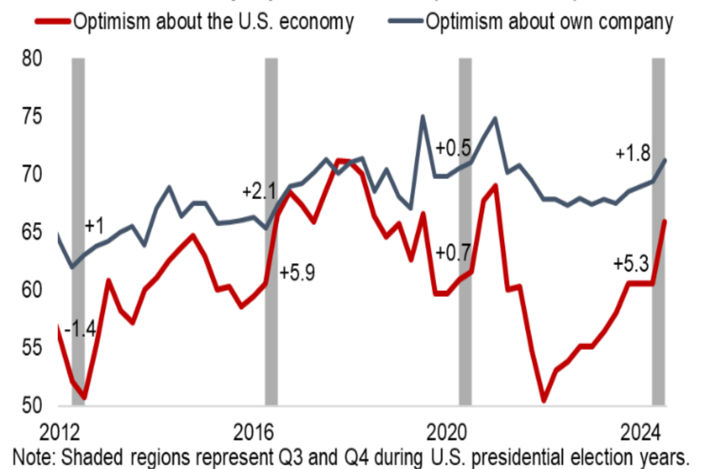
Consumers are more positive post the U.S. election, with the Conference Board Consumer Confidence and Michigan Consumer Sentiment Indices both showing gains in November. Meanwhile, the U.S. labour market is moderating, yet not deteriorating. The November jobs report, where unemployment rose slightly to 4.2%, increased the probability of another 0.25% cut by the U.S. Federal Reserve (Fed) in December. As we head into 2025, the dual monetary and fiscal policy levers have potential to further support U.S. economic momentum.

A balancing act – multiple policies in flux

For markets, attention is focused on the sequencing and detail of policy priorities for President-elect Donald Trump after his inauguration on 20 January 2025. Given the Republicans will have a majority in the House and the Senate, they may wish to move policies through relatively quickly, ahead of the mid-term elections in 2026.

Sweeping policy changes, if implemented, will reverberate through the global economy in various ways. In the near term, the prospect of Trump's stimulative policies, which broadly benefit the U.S. corporate sector (lower corporate taxes, deregulation and a pro-business environment), should keep U.S. sentiment relatively positive and risk appetite buoyant.

The recent CFO Survey showed optimism about the overall economy increased broadly in the fourth quarter, with executives upgrading their expectations for near-term economic growth. The increase was starkest among smaller firms. This was reinforced by November's U.S. NFIB Small Business Survey showing optimism surged to the highest level since June 2021, with business expansion plans sharply higher.

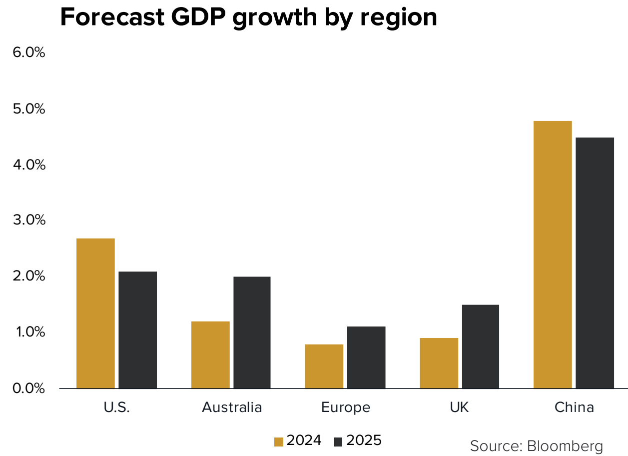


Source: The CFO Survey

The current supportive economic conditions and positive market momentum may persist well into 2025. However, balancing a pro-growth and U.S. protectionism agenda against inflation and fiscal deficits is a complex challenge in the medium-term, requiring careful navigation. Policies may lead to higher inflation, higher interest rates and ultimately slow the U.S. economy down the track.

Rest of the world faces challenges

Outside the U.S. the picture is less positive. The European economy is advancing at a modest pace (with significant variation across nations) and earnings growth remains soft. Germany is stagnating, with falling business confidence and core sectors of its economy, such as the auto industry, under pressure. The ECB is now three interest rate cuts into its easing cycle, which may prove supportive. However, the prospect of tariffs to be introduced by the U.S. – the European Union's largest export market – could trigger further economic contraction and significantly impact their auto and pharmaceutical industries.



Meanwhile, China faces its own set of challenges, and the economy remains sluggish. Additional stimulus measures are not yet enough to fully revive the economy and a trade war with the U.S. is looming.

Domestically, the outlook for the Australian economy and company earnings looks lacklustre despite its longer-term positive structural prospects. Growth remains very soft and is still around its weakest level (excluding COVID) since the early 1990s. We are in a per capita recession. While government spending and public investment are providing support, the private sector is flat. The Reserve Bank of Australia (RBA) is unlikely to begin cutting rates, while services inflation remains elevated (currently at 5% annualised) and productivity remains weak – market expectations for the first rate cut has moved to April 2025, well behind other developed market peers. Meanwhile, a weaker economic growth profile for China (and the threat of U.S. tariffs) has negative implications for Australia, particularly the resources sector.

Reasons for some caution in 2025

Despite a resilient U.S. economy and pro-growth agenda, there remains uncertainty and complexity around the global implications of simultaneous policy shifts. There are some areas of concern which may materially change our more optimistic view as we move through 2025:

1. U.S. trade policy – negotiation or retaliation to potential tariffs

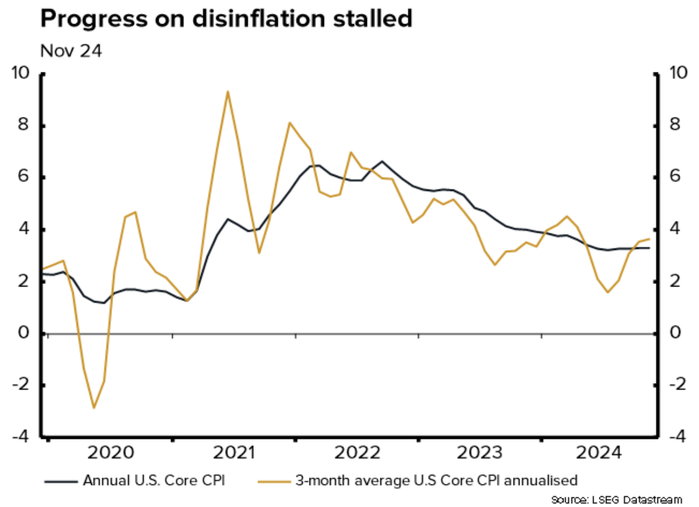
The potential announcement and implementation of multi-lateral tariffs by the U.S. (and the global response) is one of the most focal risks for global markets.

New tariffs may adversely impact the global economy and revive inflation. From a U.S. perspective, tariffs increase input costs for importers, erode corporate margins and increase prices for end consumers. The recent lift in manufacturing new orders in the latest PMI data indicates U.S. companies may already be preparing for increased tariffs by forward ordering to stockpile ahead of higher prices. Tariffs ultimately stoke inflation, drive higher rates and slow economic growth – providing potential headwinds as we progress through Trump's term in office.

More broadly, increased protectionism may provoke retaliation, significantly alter global supply chains, erode diplomatic relations and worsen economic outcomes for all parties involved. Given Australia's leverage to China, U.S.-China policies are an important focus for our export markets and economic growth outlook.

2. Resurgence of Inflation, leading to higher rates

U.S. disinflation has showed signs of stalling, reflecting robust economic activity. Three-month average core inflation, annualised, rose to 3.66% in November (from 1.58% in July). Looking ahead, certain key policies, if implemented, are also likely to further stimulate inflation: 1) tax cuts supporting economic growth, business investment and consumer spending; 2) the nature of tariffs introduced, with higher costs being passed onto consumers; and 3) potential labour shortages in certain industries from tighter immigration policies, pushing up labour costs. At the same time, structural changes such as the energy transition imply structurally higher inflation over the decade ahead.



Potential resurgence in inflation makes the task of reducing rates back to neutral levels challenging – there is a risk that rate cuts may prove shallower or slower than forecast. The market is currently pricing in a further 80 basis points of rate cuts by the Fed by end of 2025, ending at a terminal rate of around 3.70%.

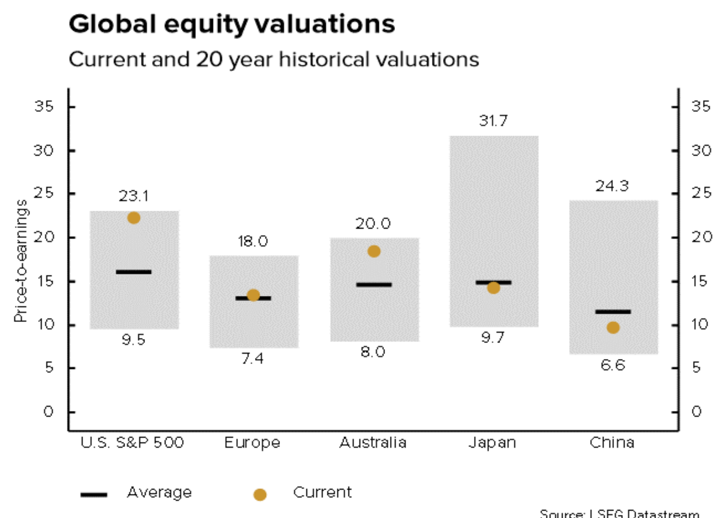
Any significant delay in reducing rates by central banks may prove unsettling for equity and bond markets. Furthermore, higher bond yields increase the cost of borrowing, therefore impacting corporate profitability, business investment and economic growth.

3. Earnings disappointment amid elevated valuations

Heading into the final weeks of the fourth quarter, analysts and companies have been slightly lowering their earnings expectations for U.S. companies. According to Factset, the S&P500 Index fourth quarter 2024 year-on-year earnings growth is expected to be 11.9% (compared to 14.5% expected on September 30). Nevertheless, this is more than double the third quarter growth rate. Analysts forecast double-digit earnings growth will continue throughout all quarters in 2025 – estimating 15.0% growth for calendar year 2025.

Given equity valuations are elevated (S&P 500 Index is trading on 22.3x price-to-earnings, well above its 20-year historical average of 16x), any earnings disappointments may lead to increased volatility for equity markets.

The U.S. quarterly reporting season commences on January 15, 2025, led by the major banks. As important barometers for broader economic health, banking results are reviewed closely for any signs of consumer weakness or credit-quality deterioration, while the extent of return to shareholders via dividends and share buybacks is also closely monitored.



Positioning amid parting clouds

The period ahead is likely characterised by significant uncertainty and change, which presents investors with opportunities. This requires more nuanced strategies and active management in order to add value and de-risk portfolios.

While we have increased optimism for equities, given the risk of an imminent U.S. recession has dissipated, elevated valuations continue to encourage allocation to alternative asset classes which currently offer better relative value – such as private credit, unlisted infrastructure, direct property and private markets equity.

Our portfolios include a blend of investments offering defensive qualities and/or consistent, stable income (such as core infrastructure, private credit) and those higher-risk higher-returning opportunities (such as venture capital).

Asset class views heading into 2025

Fixed Interest

We prefer Australian fixed interest exposure versus international. A more persistent domestic inflation profile means that the RBA will continue to lag rate cutting cycles in other developed markets. As a result, we expect domestic yields to remain higher and more attractive than international yields.

We recently reduced our exposure to government bonds within our fixed interest allocations as the risk of a U.S. recession decreased. Furthermore, holding long-dated government bonds is less attractive on a risk-adjusted basis given a potential deluge in Treasury issuance, a potentially shallower Fed rate cutting cycle and the current lack of compensation for taking on duration risk.

We have instead increased our credit exposure. Although credit spreads are historically tight, we believe they can remain so if economic growth remains resilient and corporate profitability and balance sheets remain healthy. Furthermore, all-in-yields for credit remain attractive.

Over the longer-term, we believe inflation will be structurally higher and more volatile than the prior decade driven by increasing fiscal deficits, changing demographics, re-wiring of global supply chains and the inflationary impact of the energy transition. In such an environment, interest rates, will likely be higher and more volatile than the past. Therefore, government bonds may not be an effective diversifier or hedge for equities, as witnessed in 2022.

Equities

Our portfolios retain a core exposure to equities. Despite elevated valuations, policy tailwinds and the economic backdrop are supportive for U.S. equities as we head into 2025. While price-to-earnings ratios are well above historical averages, when adjusting for the projected earnings growth profile for the S&P500 Index, valuations are less extreme given attractive earnings growth forecasts, particularly for the Magnificent Seven companies.

Company earnings are expected to continue growing in 2025, and U.S. corporate tax cuts, if enacted, will provide a one-off boost to earnings (and potential impetus for further buybacks or dividends). We closed our small underweight to developed market international equities during the quarter, with a bias towards U.S. equities, while remaining underweight Europe which faces multiple headwinds. We have increased our small and mid-cap exposure, with a U.S. focus, which we expect to benefit from a pro-growth agenda and monetary policy easing.

However, we are cognisant of the risks. Valuations leave little room for earnings disappointment, and we expect the market to be sensitive to negative surprises. Meanwhile, the potential implementation of U.S. tariffs (or a trade war) may impact importers' profitability and lift consumer prices.

Our preference is to focus on high quality companies with diversified business models, strong balance sheets, pricing power, recurring revenue streams and which are well positioned to benefit from long-term structural trends. We favour select exposure to healthcare, energy, copper, financials and technology leveraged companies.

We remain moderately underweight Australian equities given elevated valuations, sluggish growth, leverage to the decelerating Chinese economy and weak earnings growth from major sectors of the ASX200 Index – resources and banks – for 2025.

Direct Property

Commercial property showed signs of recovery over the September 2024 quarter, as capitalisation rates across most sectors appeared to stabilise. This indicates that market fundamentals may be nearing a low point. The office sector remained the weakest performer, while the retail sector was the strongest.

Improved market sentiment was evidenced by an increased number of completed transactions during the third quarter. There are signs of vendor price expectations becoming more realistic, and we expect transaction activity to continue to rise over the next 12 months. In addition, forecasts for Australian interest rates to fall in 2025 bode well for liquidity and asset values in the year ahead.

We believe long-term investors stand to benefit from counter-cyclical opportunities to acquire assets at attractive pricing as the market broadens its recovery. We remain focused on Australian property in central locations with high quality attributes where longer-term trends are supportive for demand. In our view, strong population growth, significant fiscal spend on infrastructure programs and higher costs (limiting construction of new buildings) will underpin demand for well-located space over the longer-term in Australia.

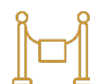
Thorough asset due diligence, disciplined pricing and active management are essential to ensure risks are managed and return potential is optimised.

Private Credit and Property Debt

We believe private credit remains attractive despite the considerable amount of recent capital inflows. Higher-for-longer short-end interest rates are beneficial for an asset class that is predominantly floating rate in nature. However, this may come at the expense of higher potential corporate defaults and losses. Therefore, active management and excellent fund manager selection is crucial to navigate this challenge.

Similarly for property debt, we expect market conditions to remain challenging for developers, owners and financiers and any sustainable signs of improvement delayed, if interest rates stay high. However, such an environment may prove conducive for fund managers who are highly selective and experienced in ensuring downside risks are addressed whilst still capturing attractive returns.

We continue to recommend combining more defensive, performing private credit and property debt exposures with selective distressed debt opportunities as an environment of higher-for-longer interest rates could create pockets of stress / opportunities in the economy.



Private Markets Equity

In 2025, we are cautiously optimistic for both private equity (PE) and venture capital (VC) investment. Despite the optimism surrounding the new U.S. administration's pro-business and policy agenda, we are observing market participants exercising caution until greater detail is released, reforms are implemented, and any potential impact on inflation is better understood. As a result, we expect the moderate deal volumes and stabilising valuations witnessed during 2024 to continue into the first half of 2025.

We continue to favour early-stage VC opportunities focused on addressing global challenges (i.e. food security, decarbonisation, waste reduction) and secondary strategies providing liquidity solutions to investors.

In PE, secondary strategies continue to be attractive in the current environment, with the ability to purchase discounted fund interests.

However, the return profile from secondaries may be flatter and longer if the exit market remains challenged. Within the buyout segment, we favour the middle market where deals are less competitive, less dependent on borrowing, less correlated to public markets and have lower valuations.

Unlisted Infrastructure

Our outlook for unlisted infrastructure remains positive, despite the potential for a higher-for-longer inflation and interest rate environment which may place downward pressure on some asset valuations.

Our focus remains on infrastructure fund managers with a disciplined investment approach – targeting assets with important characteristics such as positive linkage to inflation (implicit and explicit) and economic growth (e.g. toll roads), downside protection, high cash flow visibility and being well positioned to directly benefit from ongoing structural tailwinds (such as the energy transition and digitisation).

We also favour broadly diversified infrastructure strategies across sectors and/or geographies to achieve more consistent returns. By taking a diversified approach, we believe investors can benefit from a more balanced and resilient portfolio through market cycles.

Please reach out to your Mutual Trust Advisor with any questions.

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