Investor Insights

December Quarter 2024

In Summary

Global equity markets reached new all-time highs in the final quarter of 2024, buoyed by improved investor sentiment following the election of Donald Trump and significant fiscal stimulus measures announced by Chinese authorities. As we move into the first quarter of 2025, markets are balanced between a resilient economic outlook and a range of potential risks that could challenge the prevailing consensus.

In this edition of Investor Insights, we delve into key economic and financial market developments from the past quarter and explore their implications for markets in the year ahead:

- The Australian dollar has faced downward pressure, driven by a robust US dollar and ongoing domestic economic challenges. Meanwhile, inflation rates in both the US and Australia continue to moderate.

- The Trump administration's anticipated trade policies have introduced significant uncertainty. However, the broader policy direction offers investors insights on potential opportunities and challenges.

- US equity market leadership is expected to be maintained in 2025 as US companies continue to grow their earnings. Strong results may broaden to new parts of the market, compared to the recent dominance of technology firms. The Australian share market may face headwinds as banks' outperformance fade.

- Chinese shares initially surged on government stimulus announcements but subsequently retreated as the specifics of the fiscal measures fell short of expectations.

Navigating a soft economic landing as the probability of an economic recovery rises

The economic backdrop suggests a high probability of a 'soft landing', characterised by moderately positive growth in the US and muted growth in Australia. Inflation is expected to moderate gradually, with labour markets normalising, prompting minor interest rate cuts by central banks.

However, recent data indicates an increasing likelihood of an economic recovery or 'no landing'. In this scenario, broader growth improves while inflation remains above central bank targets, and labour markets stay tight. This dynamic may lead central banks to adopt a more hawkish stance on interest rates, with no additional interest rate cuts and the possibility of interest rate hikes in the future. This scenario is predominantly a US-centric outcome rather than Europe, Asia or Australia.

While global financial markets are supported by several positive factors, risks remain that underscore the importance of maintaining a prudent and diversified investment approach.

The Australian dollar is under pressure as the US dollar strengthens

The US dollar has strengthened since the US elections, maintaining its positive momentum over the last year.

The anticipated policy direction of the US involves deregulation, tax cuts, and tariffs which all point to continued strength of the US dollar in the short term. Despite short-term strength, the US dollar is structurally overvalued but may remain so for a prolonged period.

Higher US bond yields also provide support for the US dollar. Current interest rate differentials between the US and Australia are weighing on the Australian dollar.

The Australian dollar has weakened in line with global peers (chart 1 – see next page) but is also facing challenges as lacklustre economic growth and significant exposure to the weak Chinese economy pressure the domestic currency.

The Australian dollar is likely to retrace some of the recent sell-off, but we have a bearish bias within a broader trading range (chart 2 – see next page).

Currencies of emerging markets and major trading partners with the US are set to face economic headwinds until there is some certainty on trade policy.

We remain cautious on broad emerging market and European exposures while positive on US dollar-denominated assets.

Chart 1: Currency performance against USD - % change since the US elections and trailing 12 months

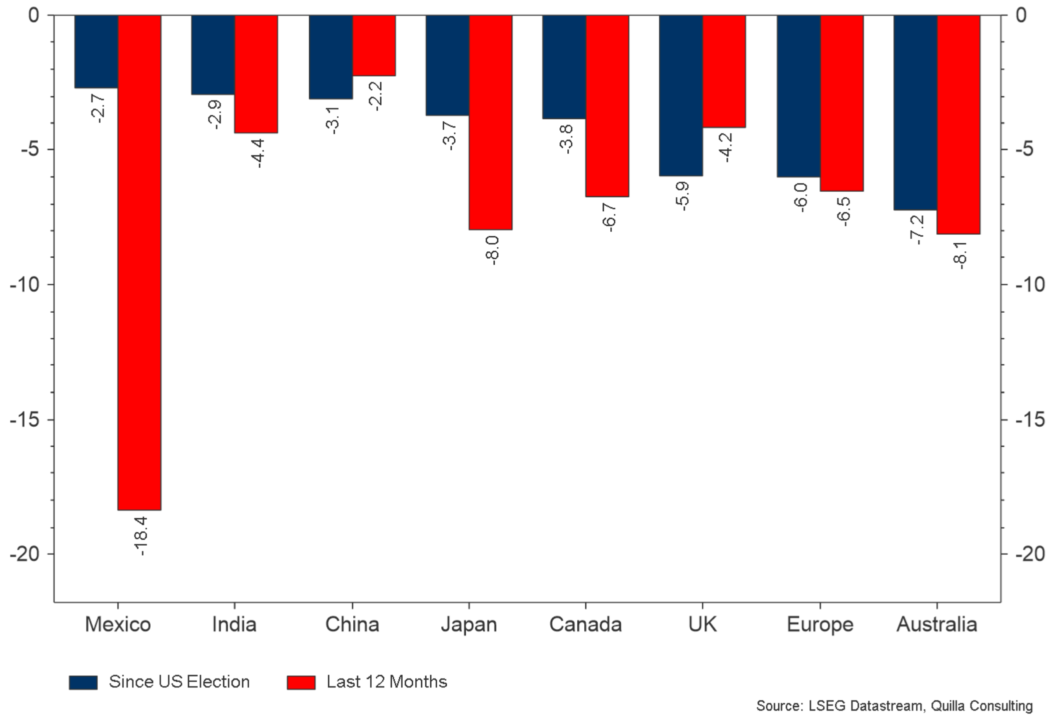


Chart 2: Australian dollar to US dollar exchange rate - trading close to the bottom of the long-term range

Australian and US inflation trend lower

US inflation has trended lower with the US Federal Reserve's (Fed) preferred inflation gauge (PCE) measuring 2.4%, close to the Fed's 2% target (chart 3 – next page).

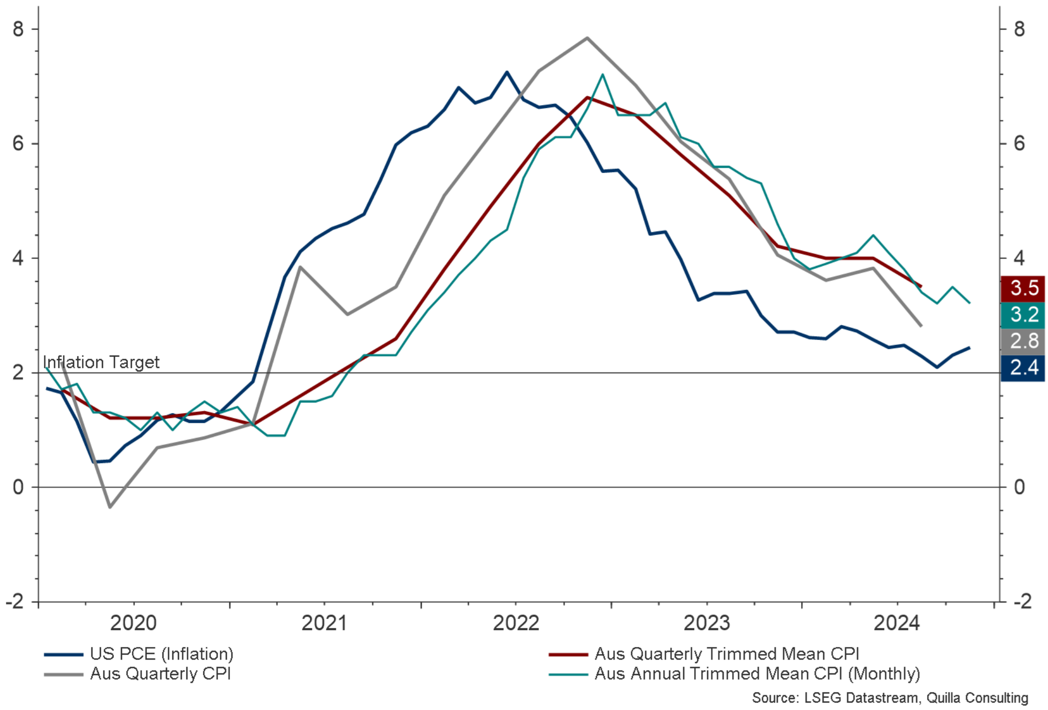
This has allowed the Fed to initiate its monetary policy easing cycle with a 50-basis point cut in September, followed by a further two 25 basis point cuts in the Fed funds rate in November and December.

Australian inflation has trended lower but has lagged global peers. The latest quarterly CPI reading of 2.8% was significantly flattered by government electricity subsidies. Removing volatile items, the trimmed mean CPI measure of 3.5% remains well above the Reserve Bank of Australia's (RBA) target range.

Within the headline numbers, services inflation remains elevated at 4.6% and has reaccelerated. Encouragingly, recent monthly trimmed mean data, while not as robust a measure as the official quarterly inflation data, has shown further moderation to 3.2%.

The RBA has remained confident in its inflation forecasts. Markets are now pricing in the probability of the first cut in the cash rate in February but a cut in the middle part of 2025 is now fully expected.

Chart 3: Australian and US inflation rates year-on-year % change



Expected policy implications of the incoming Trump administration

The incoming Trump administration has been vocal in their policy direction. Table 1 provides a summary of the broad policy themes and their possible implications.

Table 1: Trump administration policies and their potential impacts

Policy	Economic impact and investment implications
Higher fiscal spending, broadly inflationary policies, and larger budget deficits	• The USD is likely to strengthen in the short term but weaken over a longer horizon. • Bond yields will rise, and the yield curve will steepen. • Upward pressure on inflation. • A more favourable environment for equities compared to bonds.
Pro-growth, domestically oriented policies	• Small caps are set to be significant beneficiaries as they were in Trump's previous term. • Industrials will benefit from increased infrastructure spending, growth and reshoring initiatives.
Curbing illegal immigration	• Stricter immigration laws will limit the supply of labour and prove to be inflationary.
Tax cuts	• The extension of the 2017 tax cuts and the possibility of further corporate tax cuts would benefit US companies.
Protectionism and tariffs	• US focused industries will benefit but US multinationals will be negatively impacted by retaliatory policies. • Emerging market assets will likely struggle, and European equity returns pressured. • The automotive industry will welcome further protection from cheaper imports. • The retail sector will be impacted by rising import prices.

Deregulation	• Deregulation is favourable to all US sectors. • The banking sector will benefit as stringent regulations enacted post the GFC are watered down.
Energy policy	• US energy production is poised to grow but industry profits will be capped by capacity constraints. • Clean energy companies may struggle as incentives are reduced.
Restoring US industry	• Materials will benefit from the push to restore US industry and promote domestic manufacturing and production.

Uncertainty will remain around the quantum, timing and impact of conflicting policies across regions and sectors in the short term. **On balance, the outlook for US growth remains more favourable than its global counterparts.**

Australian banks' stretched valuations

Australian banks make up close to a quarter of the ASX200, measured by market capitalisation, and are a significant driver of the domestic share market.

Chart 4 (see next page) shows that Australian banks currently trade at historically high valuations (bottom chart) as share price appreciation (top chart) has not been met with significant earnings growth (middle chart).

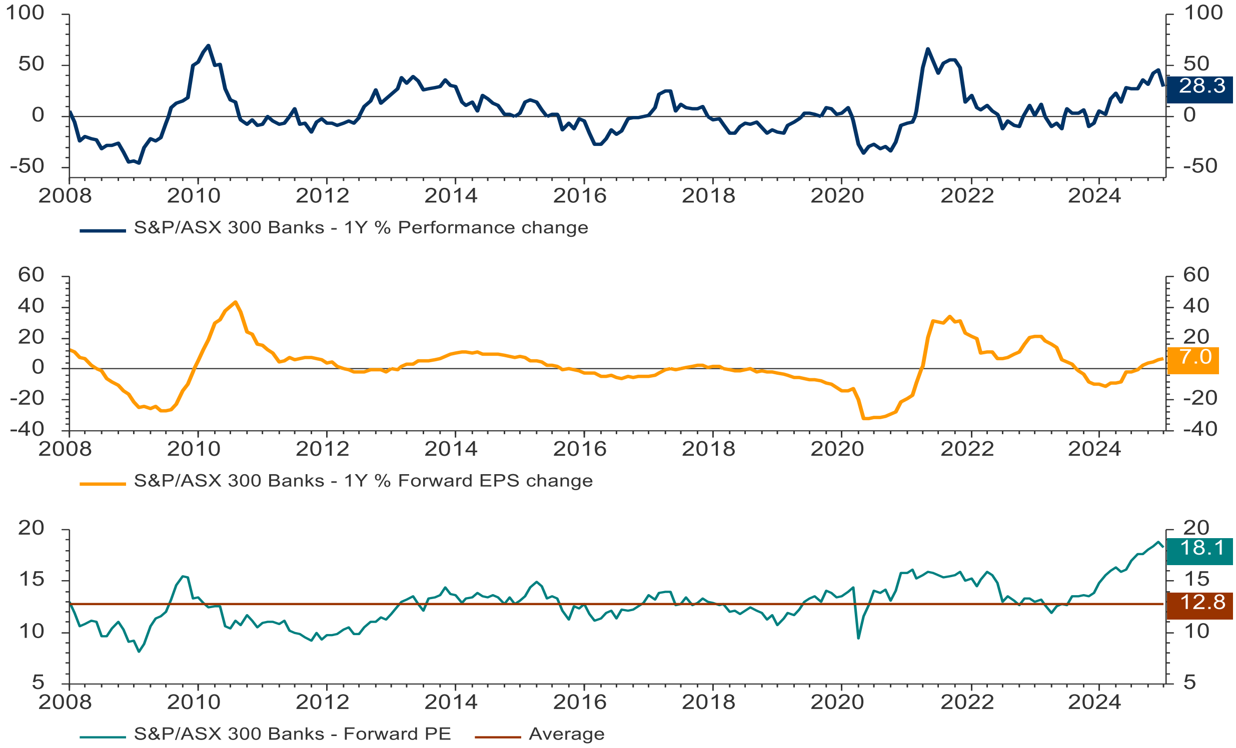
Australian banks trade at an 18x price to earnings ratio (P/E) (bottom chart), a significant valuation premium compared to historic valuation levels of 13x, and to the 10x P/E of global banking counterparts.

Australian banks, however, deserve a valuation premium compared to global peers given their quality and ability to generate higher returns on equity (ROE).

Banks' share price movements go through distinct cycles (top chart) **where periods of strong performance are usually followed by softer returns.** Banks' returns have started to moderate from their peak of over 40% in 2024 (top chart).

We believe the return prospects in the short to medium term will be much lower, given the already elevated valuations and lack of earnings growth potential.

Chart 4: Australian banks
(rolling returns, earnings growth and valuation)



Source: LSEG Datastream, Quilla Consulting

The broadening earnings profile for US equities

The Magnificent 7 (Mag 7) has been the principal driver of global equity returns over the last two years, justified by their significant rise in both revenue and earnings.

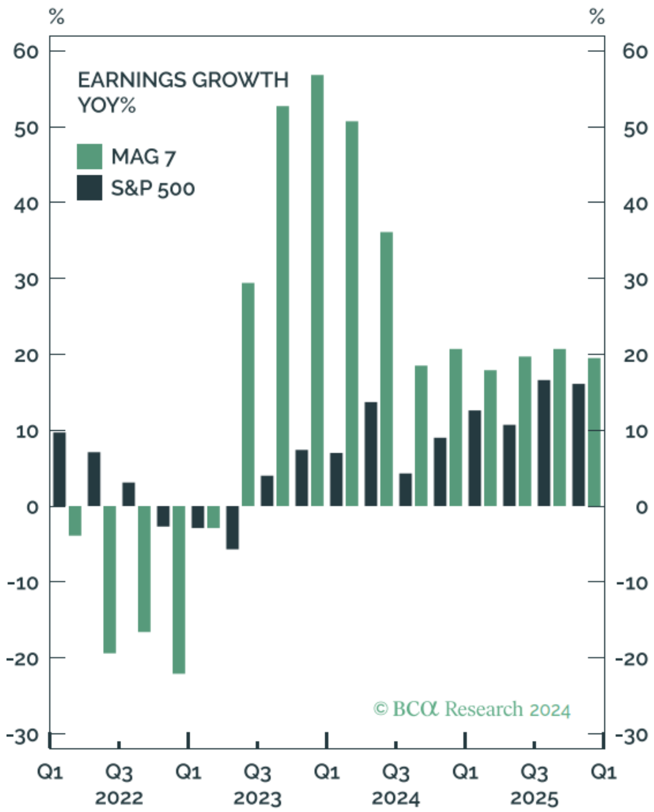
Year-on-year earnings growth is now expected to slow to a more normalised, but still solid, pace.

The slowing rate of growth may not be enough to justify continued strong returns for some of the Mag 7 whose growth is now below 20%.

However, the earnings growth of the broader S&P500 is expected to accelerate in the coming quarters, with earnings expected to grow by 14% over the next 12 months.

The broadening earnings profile supports the investment case for US equities and maintaining a diversified exposure to the region.

Chart 5: Magnificent 7 vs S&P500 earnings growth (YoY %)



SOURCE: BLOOMBERG INTELLIGENCE

*The Magnificent 7 (Mag 7): Apple, Microsoft, Amazon, Nvidia, Alphabet, Tesla, Meta

Tailwinds for US small and mid-cap equities

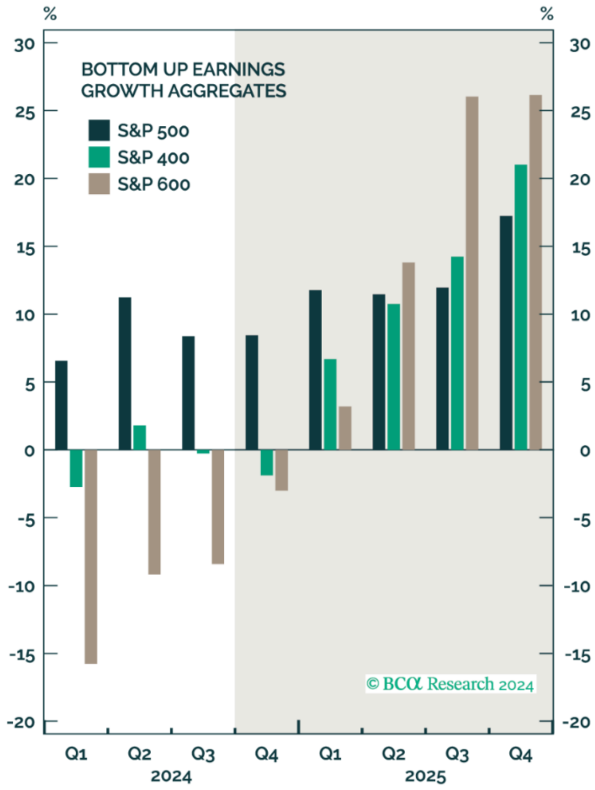
Forecasted earnings growth for the S&P 600 (small caps) and the S&P 400 (mid-caps) are expected to accelerate and outpace that of S&P 500 (large caps) in 2025.

Chart 6 highlights gradual improvements in year-on-year earnings growth across these sectors.

The expansionary fiscal policy of the Trump administration also provides further support for domestically orientated companies which make up a much larger portion of the small and mid-cap sectors.

Our view remains constructive on US small caps given the combination of earnings growth and improved investor sentiment towards the sector.

Chart 6: Earnings growth for US small, mid and large caps equities (YoY %)



SOURCE: LSEG I/B/E/S.

Chinese shares surge on stimulus measures

Economic growth in China has faltered over the last few years, weighed down by several factors. The weak and highly indebted property market has been the most significant headwind to economic growth.

To support the economy, Chinese authorities have delivered minor stimulus measures in the first eight months of 2024. However, in September authorities announced a significant monetary stimulus package and stated that a significant fiscal stimulus package would be announced soon after.

The Hang Seng Index experienced strong gains of over 30% starting in September (chart 7 – see next page) on the back of these announcements as investor sentiment improved, with technical indicators (e.g. Relative Strength Index) reaching overbought levels never experienced before.

The Hang Seng Index has pulled back since the October highs when the details of the fiscal stimulus package were released, underwhelming market expectations.

Many Economists have commented that the stimulus measures have generally been piece-meal, and don't address some of the more fundamental imbalances and weaknesses that characterise the Chinese economy including excessive and increasingly unproductive investment spending, reliance on exports for economic growth and very high household savings rates due to a lack of social safety net.

Chart 7: Hang Seng Index performance (rebased to 100)

Source: LSEG Datastream, Quilla Consulting

Outlook

As we move into 2025, there are several reasons to maintain a positive view of the global economy and financial markets. The constructive global growth outlook, led by the strength of the US economy, sets a solid foundation. Inflation is continuing to cool, creating room for further monetary policy easing. Resilient labor markets domestically and across advanced economies support a stable economic environment. Additionally, optimism surrounding structural growth themes, such as artificial intelligence, continues to support equity markets and bolster investor sentiment, providing a favorable backdrop for financial markets in the year ahead.

That said, these positive dynamics must be considered alongside potential risks. Policy uncertainty under the Trump administration poses opportunities and challenges for various segments of global markets, including Australia. Furthermore, unexpected shocks to economic growth, deviations in inflation trends, or weaker-than-expected corporate earnings could disrupt market expectations and sentiment.

In this context, maintaining a well-diversified and strategically positioned portfolio is key to optimising returns while navigating uncertainties. A disciplined approach to risk management will remain essential in leveraging opportunities and addressing the challenges that 2025 may bring.