December 2024

Market Outlook.

Trump Bump to Persist

Foreword

'Who could've known' is an apt description of financial markets over the past few years. From runaway inflation, to the fastest rate tightening cycle we've experienced in 30 years, or the resiliency of economies (Australia included), to record equity markets and President Trump's (miraculous) comeback.

Despite the constant fear that something is about to go wrong, US equities have risen 162% from their pandemic lows. Even the Australian equity market, while a significant laggard, is still up 80%. Quite remarkable all things considered, but it supports the idea that markets don't need perfect conditions to go up, or to break with tradition.

Sometimes better than expected is enough, and in the case of equity markets, that rather accurately describes the past four years. As we head into a Trump 2.0 world, where we know to expect the unexpected, it doesn't mean markets can't trade higher, and that's exactly how we see the backdrop for 2025.

Instead of being fearful, we are pragmatic. We think there is a difference between campaign promises and how those promises are delivered. As a result, it's necessary to calibrate expectations, and for now, we don't think Trump's key policy proposals are enough to dislodge the US economic cycle, nor the nascent global recovery.

Similarly, we doubt that a little more inflationary pressure will threaten the path of monetary policy makers, who have embarked on a global rate cutting cycle, or cause long bond yields to decouple from where the economic cycle is headed over the coming year.

On this basis, and with full understanding that the Trump presidency is likely to create policy uncertainty, our view remains that ongoing rate cuts will support a modest economic recovery – albeit somewhat desynchronised across the globe.

A modest recovery alongside lower inflation and easier monetary conditions should be positive for equity markets, with performance beginning to broaden outside of the structural and/or defensive growth beneficiaries. While we think the easy valuation gains have already been captured, we don't believe they're at levels which constrain further index upside, either here or abroad.

Similarly, while a further rise in long bond yields may begin take the steam out of equities, at this stage we don't think fears of fiscal largesse are enough to see them decouple from a trend like global growth backdrop.

For investors, we remain risk-on and don't think it's time to position more defensively despite macroeconomic uncertainty and stretched valuations. While these headwinds are likely to raise volatility (by reducing the cushion for disappointment) and slow the pace of gains which have been well above trend for some time, we don't think they will be a constraint for further gains.

A well-diversified portfolio remains the best hedge against market uncertainty, but there are also other ways to circumvent policy risk by focusing on areas and/or exposures that are structural, or where there is more certainty around the underlying trend. This includes falling short-term interest rates, themes such as Artificial Intelligence (AI), clean energy transition, trades benefitting from uncertainty (such as gold), or areas where there is a strong (relative) valuation appeal. We remain focused on the underlying improvement in the global economy and easing financial conditions. The rest, while interesting, is noise.

Commonwealth Private

Global Economics:

Recovery intact despite Trump 2.0

- While Trump 2.0 introduces volatility and uncertainty into the macroeconomic outlook, policy proposals – outside of a trade war – pose only a modest growth drag.
- The global rate cut cycle is now firmly underway and won't be derailed by the threat of US trade policy pushing inflation higher.
- China needs to do more to raise confidence that recent policy stimulus is enough to underpin the economy – we think it's coming.

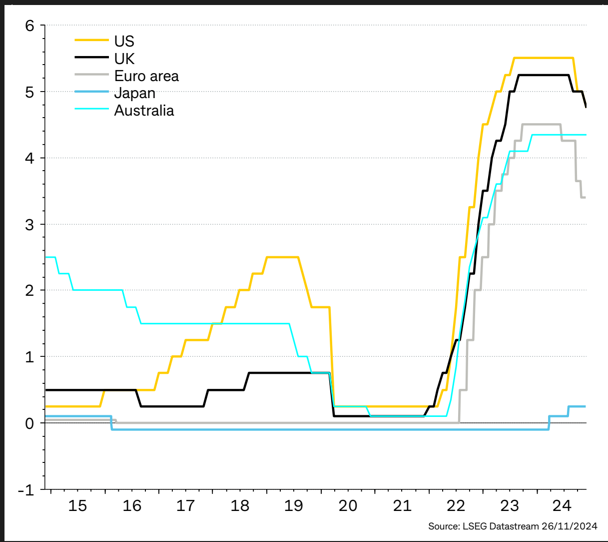
The global economy continues to inch its way towards recovery from a monetary policy induced slowdown, albeit at varying speeds across both the developed and emerging world. Although the US election result raises some uncertainty around the growth outlook due to President-elect Trump proposed tariff agenda, we don't think it will derail the global recovery outside of a full-blown trade war, which is in no-one's interests, including the US.

At this stage, we believe the deceleration in trend inflation rates is providing most central banks with the capacity to ease policy rates at a gradual pace, or faster, should economic uncertainty begin to pick up. It's unlikely that we'll see an aggressive monetary policy easing cycle in 2025, but the underlying strength of the US economy is key to ensuring the global growth backdrop remains strong.

Despite a co-ordinated and meaningful set of policy announcements made by the upper-levels of the Chinese government in early-November, hope that this would mark a turning point for the Chinese economy quickly faded. We're not giving up on the expectation that more will come, or that with Trump's proposed tariffs, more is required.

Global monetary easing continues

Central Bank Target Cash Rates (%)



While US political developments have introduced noise into the outlook, the three most important central banks – the US Federal Reserve (Fed), the European Central Bank (ECB) and People's Bank of China (PBoC) – are still in policy easing mode, alongside the Bank of England, Bank of Canada and various emerging market central banks. We think this is enough to backstop the downside and more likely boost the upside as we move into 2025, even for Europe, which continues to disappoint.

The wild cards for the outlook include further escalation in the Ukraine-Russia conflict and/or Middle East tensions boiling over into higher oil prices. However, to date these risks have remained localised, and this remains our base case. The recent rise in long bond yields is concerning, but they haven't decoupled from a modest growth and declining inflation outlook. We think both economies and markets can absorb slightly higher long rates, but if Trump's policy proposals do prove inflationary, higher bond yields would be a major risk for cyclical improvement.

Australia Economics:

Rate cuts pushed to next year

- Given the impact of rate hikes on consumer spending, the local economy remains subdued, but resilient.
- The disinflationary trend continues, but a persistently strong labour market has all but killed off rate relief in 2024.
- CBA now expects the first rate cut in February 2025, but there is a clear risk to a later start to the easing cycle.

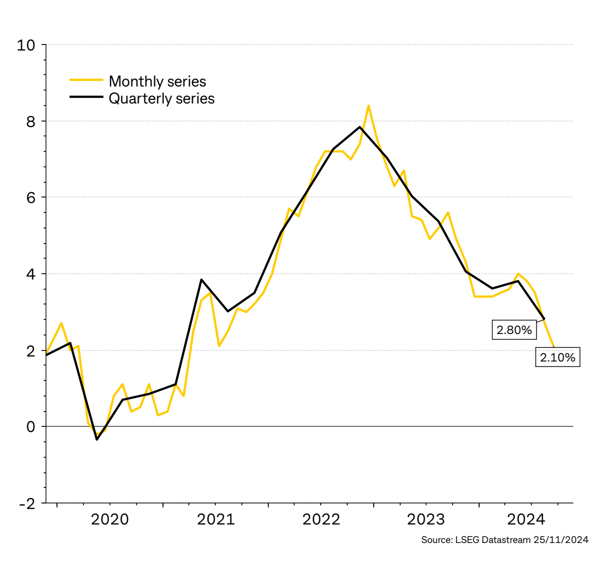
The Australian economy has remained lacklustre despite a slightly firmer consumer pulse of late, driven by tax cuts and lower job security fears. Updated consumer and wage price data continues to signal a disinflationary trend, but with the labour market remaining strong, it appears interest rate cuts will be delayed until early-2025 at the earliest.

The Reserve Bank of Australia (RBA) continues to balance a gradual, but still elevated, core inflation rate, against a tighter than expected labour market. The most recent labour market data highlights a continuing low unemployment rate of 4.1%, albeit employment growth of 15.9k was below consensus and recorded the slowest gain since March 2024. Overall, there remains little evidence that the persistent weakness in private demand growth has spilled into job losses.

The latest Board Minutes from the RBA noted it's too early to judge what the implications of Trump's future policy changes in the US will have on the local economy, and that the RBA is highly reliant on incoming data. To this end, CBA now believes that the RBA would only consider cutting the cash rate in February 2025 if the economic outlook has weakened relative to the latest forecasts.

Inflation under control

Australian Consumer Price Index (% YoY)



While market consensus still stands at February 2025, many economic forecasters have delayed their views to mid-2025.

By the end of 2025, CBA now expects a lower ~100bp of policy easing, which would take the cash rate to 3.35%. This won't come as comfort to those domestic sectors that continue to struggle under elevated cost-of-living pressures and rents, including small business and discretionary retail.

Overall, we remain sanguine on the domestic economic outlook. The labour market and overall economic growth pictures continue to be resilient to rate hikes due to strong population growth and high government spending, and we think the economic trajectory will improve into 1H25, albeit gradually.

Equities:

The Trump Bump didn't disappoint

- The incoming US administration, corporate earnings, and the central bank easing cycle continues to support equities.
- While valuations are elevated, we don't foresee a precipitous drop, more likely a slowing in the pace of gains.
- Higher bond yields will constrain long duration plays (such as Tech) however the rotation into small caps, value and emerging markets should continue into 2025.

When ascending Mount Everest, climbers traverse what is known as the 'death zone', a height at which humans cannot survive a prolonged period due to a lack of oxygen. In markets, as equities have continued to rise, the questions facing practitioners are whether valuations are also scaling the hypothetical Everest at too high an altitude (and will be forced to descend) or are well enough acclimatised to continue their ascent. We are in the latter camp, with enough good news 'oxygen' left in the tank.

President-elect Trump's emphatic election win has given equities conviction that the coming years will be met with a market friendly US administration, unimpeded on delivering its policy agenda. Pro-business policies favouring deregulation and tax cuts benefitting the corporate sector are key positives. The less market friendly consequences, which include inflationary pressures from tariffs and fiscal largesse have not caused too much consternation yet, despite rising yields bringing the equity risk premium to multi-decade lows.

Other good news continues to be recorded in corporate earnings which depict a resilient consumer.

Equity markets hitting fresh highs

Price Performance (Indexed to 100 as at 1 Jan)

Third quarter reporting from Mastercard noted, "We continue to see positive trends from a consumer health standpoint. They're spending in a very healthy manner." US banks also reported domestic consumers appeared to be on a solid financial footing, helped by a resilient job market and wage growth that has outpaced inflation. US banks also suggested the economy has either reached, or neared, a soft landing. All good news for equities.

Finally, the Fed continues to ease policy in a considered manner as inflation continues to trend toward its 2% objective. As we have said before, the Fed is the only central bank that matters. All others, including our RBA, play second fiddle.

So, the good news oxygen has continued to flow to equities and valuations are well supported at these levels. However, having run so far and so fast, we think gains will moderate in the weeks and months ahead. In other words, you can't climb the mountain too fast without catching your breath along the way.

Fixed Income:

Higher for longer

- A higher for longer market interest rate environment is constructive for fixed income given the elevated yield potential on offer.
- Despite the recent back-up in bond yields, the global policy easing cycle remains intact.
- Tight credit spreads necessitate a preference for higher quality issuers and actively managed fixed income credit exposures.

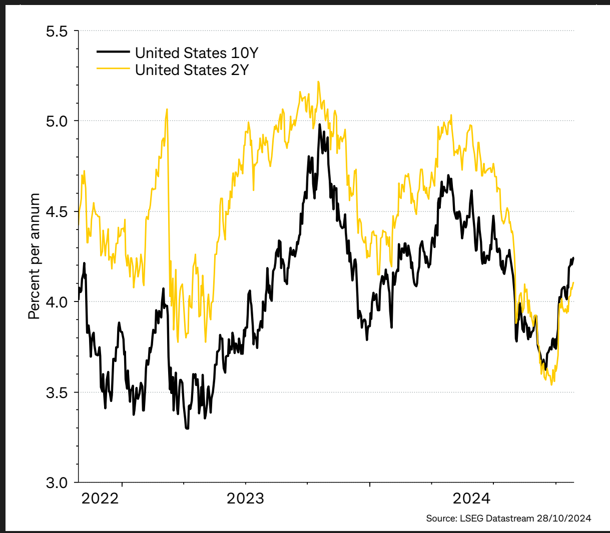
Market yields edged further higher in November following the results of the US election and the implications for Fed monetary policy going forward. With shorter and long-dated US bond yields now ~0.8% higher since mid-September, US markets have moved from pricing in around 2.25% of rate cuts by the end of 2025, to only circa 1.00%. CBA has now removed two 25bp Fed rate cuts from its forecast and expects the upper end of the Fed Funds rate to now bottom at 3.75%.

A higher for longer market rates environment is constructive for fixed income driven by the elevated yield potential on offer, while offering protection against downside risks. Furthermore, heading into 2025, the global divergence in economic growth, pace of central bank easing and market yield levels bodes well for a constructive backdrop for bond investors.

Despite higher market yields, the global rate cut cycle has continued, with key central banks maintaining policy easing last month, including the Fed, PBoC and Reserve Bank of New Zealand. Ever the outlier, the RBA is now not expected to start easing this year, with many economists also pushing back first rate cut forecasts to mid-2025.

US bonds higher on stronger growth

US Government Bond Yields %



Primary and secondary credit markets remained supportive in November with solid new issuance providing fixed income investors with sound choices to deploy capital. However, with recent tightening, market credit spreads are now pricing in little margin for error, especially in US markets which are now trading at pre-GFC tights. This drives our ongoing preference for higher quality, investment-grade credit issuers.

We believe this environment of elevated bond market volatility, low credit spreads, and differing regional economic and credit fundamentals is a reminder of the benefits of investing through a diversified fixed income credit portfolio manager that actively manages interest rate and credit spread risks.

As a key example, October was a tough month for passive, indexed-based, long duration investors with the local AusBond Treasury Index down over -2%. In contrast, key absolute return-based fixed income funds reported materially positive returns in October and have maintained that run rate in November.

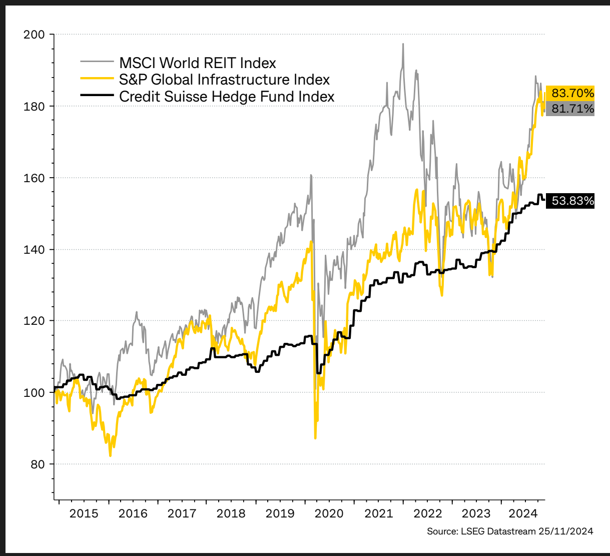
Real Assets and Alternatives:

A lot to like in this space

- Real Assets such as Property and Infrastructure provide long-term investment stability.
- Within Alternative Assets, Private Credit offers enhanced yields, Private Equity (PE) provides access to opportunities and participation in developing businesses and technologies, Hedge Funds aim to provide returns that are de-correlated to traditional assets.

Alternative investment returns

USD Total Return



Real Assets: Property and Infrastructure are a growing component of everyday investing.

Commercial property has been challenged over the past couple of years, most notably in the office sector. Recent activity indicates that Australian commercial office valuations are stabilising, while retail property is showing signs of increased demand. Non-traditional sectors such as data centres and commercial residential (build to rent, student accommodation) are presenting growth opportunities.

In infrastructure, cloud computing and AI are driving renewed demand for electricity generation (traditional as well as renewable), robust electricity infrastructure (such as grid-infrastructure, and energy storage), which will provide a base for infrastructure investment and returns in the decade to come.

Alternative Assets: We break Alternative Assets into Private Markets and other alternatives (Hedge Funds).

Private Markets: Private debt investments provide attractive returns, underpinned by the recent increase in short-term floating interest rate benchmarks.

Well-chosen PE investments continue to present sound investment opportunities, in both primary and secondary markets. In secondary markets, liquidity demands of existing investors are providing attractive discounts to holding back investment until sufficiently compelling investment opportunities arise. We continue to favour established PE managers who have proven track-record through multiple investment cycles.

Hedge Funds: Individual hedge fund managers can provide strong returns over time, providing additional portfolio diversification through uncorrelated return drivers.

We believe well-selected Real Assets and Alternatives provide sound investment opportunities, both as standalone investments, and as part of diversified portfolios. However, investment selection is paramount, as the risk characteristics of each strategy vary significantly and require specialised investment expertise to consider and mitigate the inherent risks. We believe the current market environment and position in the monetary easing cycle will be conducive to the generation of returns across these asset classes over the medium term.