February 2025

Market Outlook.

"Sustained Optimism"

Foreword

Throughout 2024, financial markets across the globe had a strong year, leaving investors asking for more in 2025. Continued strength in the US economy has propelled market equities to deliver returns of 19.2%, while the S&P 500 posted an impressive 25% gain over the year. Notably, this is the fourth time in six years the Index delivered returns of 20% or better. Last year's rally was fuelled by technology and AI stocks, with the NASDAQ up 29.6%.

The market gained strength over the year thanks to the US economy moving closer to a soft landing. Additionally, post-election optimism in the US contributed to gains, with markets responding favourably to expectations of tax cuts and regulatory easing anticipated during President Trump's second term.

Against this backdrop, the year's finish was subdued when the US Federal Reserve (Fed) threw cold water on markets by signalling plans to only reduce rates twice in 2025, a more conservative approach than the anticipated four cuts.

Looking ahead we expect global growth will moderate but remain resilient, led by the continuation of US exceptionalism. The fight against sticky inflation has made significant progress towards central bank targets, but divergence in the supply-demand imbalance may see greater disparity in the disinflation process going forward. As a result, we expect a less synchronised and slower pace of monetary easing, as fiscal concerns take centre stage. For many economies this means interest rates will settle higher than pre-GFC.

An open question remains on what to expect from President Trump administration's use of tariff policy – although we are already seeing early indications of his intent. However, lower taxes, deregulation and potentially lower oil prices could help offset the impacts of such tariffs on inflation.

Beyond potential sources of disruption to the macroeconomic environment, investors should pay attention to extremes in relative valuations and concentration. The S&P500 is trading at a historically high forward P/E ratio of 21.4x. The concentration of the 10 largest stocks is 39% of the total market, with the US now accounting for a record 67% of total global market capitalisation. These extremes in valuations are a better guide to long-term performance and where the risks lie, should markets suddenly turn.

Despite stretched valuations, solid economic and earnings growth in the US, combined with relatively loose financial conditions should provide continued near-term upside for equities. US equities have persistently outpaced global peers, and we believe that could continue, especially with the continuation of the AI mega trend that is anticipated to benefit US stocks more.

Back home, the ASX returned 11.4% in 2024 led by the technology sector, whilst resources lagged, as lower commodity prices drove downgrades to valuations. The ASX 200 currently trades at a forward P/E ratio of 19x, well above long term average. Within the Index, the concentration of the Big Four banks has continued, now accounting for 30% of the total market cap.

Australia's outlook remains modest as private demand remains soft and Government spending comes under the microscope ahead of the pending Federal election. While economic growth should improve gradually over 2025, it's likely to remain below trend, while households' real incomes should improve with lower taxes and inflation.

Continued disinflation over 2025 will likely see the Reserve Bank of Australia (RBA) commence its easing cycle between the February and May meetings. CBA expects three rate cuts in total for 2025. The RBA remains data dependent and aware of the risk that a big spending budget in the lead-up to the next Federal election could have on consumer spending and inflation.

Global Economics:

At cruising altitude, but possible turbulence ahead

In 2025 we expect ongoing moderation in inflation and further monetary policy easing in most key economies, including Australia. Global growth will moderate but remain resilient, led by the US economy. We expect global economic growth of 2.9% in 2025, slightly above 2024's anticipated growth of 2.7%. The disparity in the pace of inflation easing across regions will see some disparity in outcomes. Technological innovation and the AI cycle is expected to remain an important driver for markets.

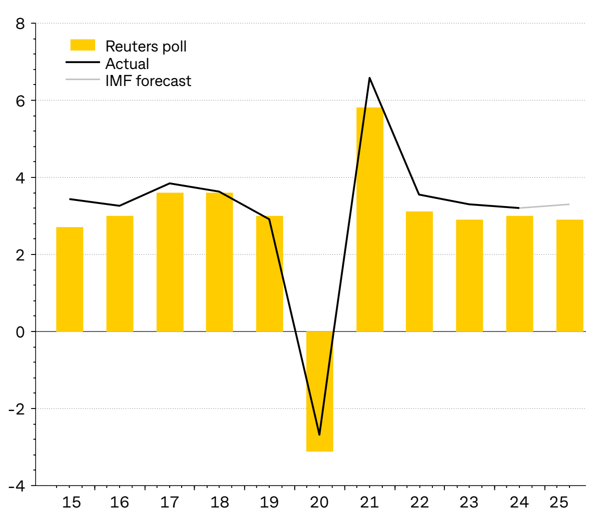
The US economy is expected to grow at a trend-like pace of 2.0% in 2025 with a still-healthy labour market, steady consumer spending, strong credit fundamentals, ample liquidity in the system, and broadening of AI-related capital spending; offset by the lagged impact of tight Fed monetary policy and the potential impact of President Trump's tariff policy. On balance, this should be net positive for the US economy through 2025.

In China, we expect economic growth to be modest in 2025 at 4.9%. The Chinese economy is still facing significant headwinds, with property market weakness, and deleveraging, keeping output and credit growth weak. However, policymakers commenced forceful easing in late-September. This recent stimulus reduced downside risks to growth by addressing structural debt imbalances among local governments, boosting growth, and improving consumer and business sentiment. Beyond that, the Chinese government's response to President Trump's policy agenda will be critical for its economy, and many of its major trading partners, including Australia. Weaker than expected Chinese economic performance would raise the probability of further stimulus, which is typically beneficial to Australia.

The European economy faces numerous challenges in 2025, which will likely see its economy continue growing below potential. Increased global trade uncertainty will keep savings rates elevated and weigh on capital expenditure. Structural issues in manufacturing, driven by higher gas prices and increased competition from China, are exacerbating its global competitiveness. With fiscal capacity limited in most European budgets, these headwinds are difficult to address. The two largest economies, Germany and France, face political challenges which inhibit their ability to implement reforms. With growth likely to undershoot and inflation moving towards target, we expect the European Central Bank to cut rates towards the 2%–2.25% estimated neutral range.

Downside growth risks are fading

Global GDP Growth Expectations



Source: LSEG Datastream 30/01/2025

Meanwhile the UK faces sluggish productivity growth, labour constraints, and inflationary impacts from higher taxes under the Labour government. The Bank of England's capacity to ease is constrained, with rates likely to decline modestly to 3.75%–4%.

Japan remains an outlier amongst developed economies, given its nominal GDP is already on an improving trajectory. Rising inflation expectations, structural labour shortages and a more flexible labour market, supported by a wage-price spiral, will anchor inflation expectations near 2%, allowing the Bank of Japan to normalise policy rates, which could rise to a 30-year high of ~0.75% by year-end.

Australia Economics:

RBA close to easing, despite mixed data signals

- The RBA continues to digest mixed domestic data, with the disinflationary trend tempered by a strong labour market.
- With core inflation moderating near 3%, rates are heading downwards, with the first rate cut expected in February to May.
- Economic growth will gain support over 2025 from rate cuts and strong public spending, with a key risk being the return of global inflationary and rate pressures.

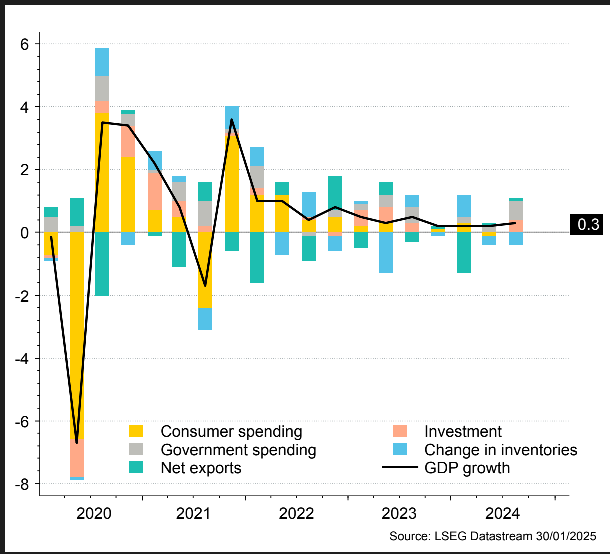
The Australian economy has displayed resilience in the wake of record-high rate hikes, driven primarily by strong public expenditure and a migration-driven surge in population growth. We expect the economy to gain support over 2025, stemming from RBA rate cuts, albeit growth will stay below trend.

As we ended 2024, the economy was offering up mixed signals to the RBA, as it slowly but surely prepares to ease monetary policy later this year. Given its dual mandate of price stability (defined by the 2%-3% inflation target), and full employment, the RBA is balancing softening inflation with a stronger than expected labour market. The recent labour data confirmed strong jobs growth and a low 4% unemployment rate (as at Dec 24, ABS), well below the RBA's 2024 year-end estimate of 4.3%.

Meanwhile, amid record high public spending, the private sector remains weak, noting the softness in household consumption. This, in turn, has dragged GDP growth lower – with the 0.8% annual growth in GDP in the September quarter the slowest annual growth in over 30 years, outside of the pandemic. CBA now forecasts GDP growth to rise from an annual rate of 1.1% in December 2024 to 2.2% in December 2025.

Australian GDP has weakened

GDP growth and contributions to quarterly growth



Source: LSEG Datastream 30/01/2025

Indeed, there are clear pockets of weakness across the economy as cost-of-living pressures, interest rates, rents and energy costs remain elevated. The small-to-medium business sector has been particularly impacted with the average monthly number of insolvencies over the past 12 months rising sharply.

Overall, with underlying inflation now back towards the top end of the RBA's target inflation range, the Board can join most other central banks in easing its domestic monetary policy setting. Markets are expecting the first rate cut between February and May, with circa 75bps of easing expected in total by the end of 2025.

A key risk to this domestic outlook and risk assets in general, is a return to inflationary pressures and even higher interest rates noting the Trump administration's pro-growth and tariff imposition agenda. Despite the global easing cycle being firmly entrenched, long-term rates have been trending higher, consistent with our "higher for longer" beliefs.

Equities:

Returns likely to moderate

- 2024 was another stellar year for equities, driven by growth and momentum, though Australia lagged its global peers.
- The macroeconomic environment should stay favourable, but volatile monthly data prints continue to dent market sentiment.
- Results season in February is a near-term focus for market to re-assess the outlook.

As highlighted in the foreword, global equities delivered another year of strong returns in 2024, led by the US indices. The S&P 500 generated 25.0% total return, following nicely on its 26.3% in 2023. Locally, despite closing 2024 with a commendable return of 11.4%, the S&P/ASX 200 was a laggard among its global peers, due much to its low exposure to high-growth technology.

Banks, rallying 35.7% in 2024, were the largest contributor to the return of the domestic equity market. With valuations well above historical average levels, and earnings outlook looking largely flat, further outperformance is not expected.

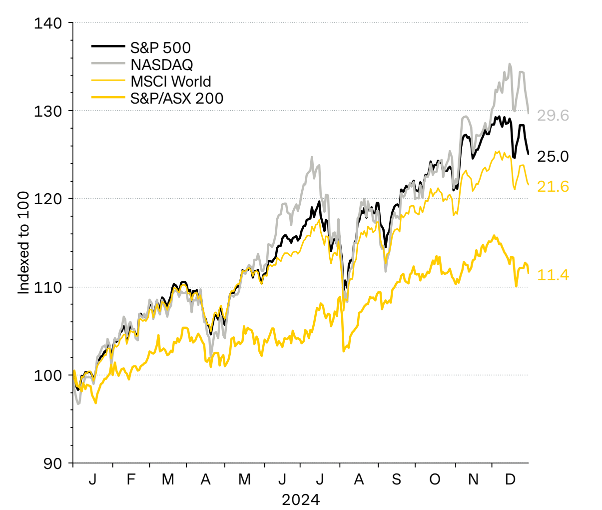
Resources, on the other hand, continued falling behind, with Energy and Materials down 13.9% and 13.7% respectively in 2024. China's late-2024 stimulus did not translate into notable commodity price increases as such announcements once did.

China has been trying to increase the proportion of its growth that is consumption-led, and appears cautious of relying too heavily on fixed asset investments to stimulate its economy. This has weakened the link between China's growth rate and commodity prices.

Major equity indices have consolidated at record levels to start 2025. Easing inflation, lower rates, strong labour markets, and the new US administration's pro-markets stance, form a sound foundation for equities.

Equities had a stellar year

Strong total returns for major indices in 2024



Source: LSEG Datastream 30/01/2025

However, the macroeconomic data points, as they always are, can be volatile at times and accordingly can have mixed implications, resulting in swings in market sentiment. Strong economic activity is generally positive for earnings, but can also drive up long-term bond yields and put pressure on equity valuations.

Domestically, most listed companies are lining up for results release in February. Earnings revision sentiment has stabilised and turned slightly positive since the December quarter, with upgrades across all sectors except Energy and Consumer Staples. The last two reporting seasons finished with modest index-level earnings per share downgrades. We expect the market to closely watch how well companies deliver on both operational and financial fronts against guidance and, perhaps more importantly, market expectations.

Fixed Income:

Higher for longer

- Global interest rates look set to be higher for longer in 2025, with the risk to the upside. Recent increases in long bond yields have occurred while global policy easing continues.
- The higher interest rate environment is constructive for fixed income investors, driven by elevated yield potential, while offering some protection to downside risks.
- Global credit spreads remain relatively tight, guiding our preference for higher quality issuers and actively managed credit exposures.

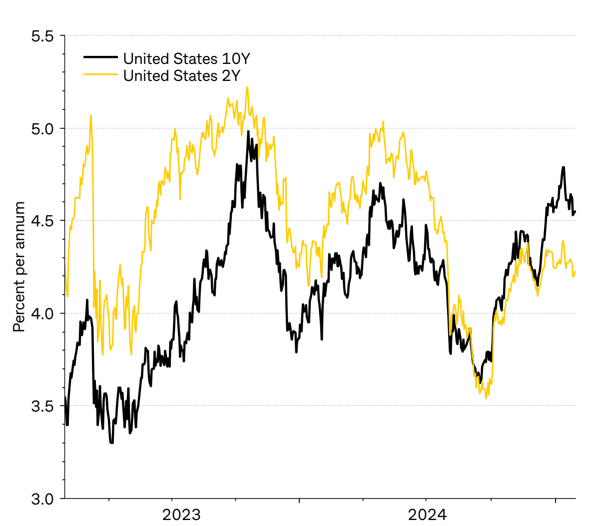
Long market yields have moved higher recently despite most developed central banks continuing to ease monetary policy settings. In aggregate, from September 2024 to mid-January 2025, 10-year US bond yields rose by ~1.2%. This included a ~0.5% rise since early December 2024. With an already strong US economy expected to receive further support from the Trump administration's pro-growth agenda, investors have progressively re-assessed the longer-term outlook for Fed policy. Commonwealth Bank (CBA) has removed two 25bp Fed rate cuts from its forecasts, and now expects the Fed Funds rate to bottom out at 3.75% (upper bound), down 75bp from the current 4.5%.

With global rates looking set to be higher for longer this year, this market environment is constructive for fixed income, reflecting the elevated yield potential on offer, while also giving some insurance to downside scenarios. To this end, a key watchout for risk assets this year is a return to inflationary pressures and even higher rates given the pro-growth and tariff policies of the Trump administration.

The RBA has remained steadfast so far despite the global easing cycle and the recent fall in the AUD. However, we believe the RBA will soon join the party and make its first much anticipated

Long US bonds yields move even higher

US 2 and 10-year Government Bond Yields %



Source: LSEG Datastream 30/01/2025

rate cut, which will place downward pressure on rates for cash-like products, including term deposits. Thus, the window for investors to move from short-term products to lock in longer-term yield potential is closing.

With credit markets remaining broadly stable in recent weeks, global credit spreads remain historically tight, notably in the US. This drives our preference for higher quality, investment-grade credit issuers and investing through diversified fixed income credit portfolio managers that manage interest rate and credit spread and interest rate risks.

As we previously flagged, in December, the Australian Prudential Regulation Authority restated their plan to phase out hybrid bank capital in favour of Tier 2 debt and a small level of core equity capital for larger banks. Margins for ASX-listed hybrids had largely priced this in. To fill the hybrid vacuum, outside of the bank equity sector, we expect growth in the Tier 2, corporate hybrid and listed investment company sectors. In 2025, we have already observed new issuances from each of these sectors.

Real Assets:

The tide is turning

- Real Assets such as Property and Infrastructure can provide long-term investment stability.
- Real Assets can also provide a hedge against the inflationary-based erosion of asset value.
- With interest rates peaks in the rear-view mirror, and the rate cutting cycle commencing globally, with expectations for major central banks to either maintain or cut rates further over the remainder of 2025, the outlook is positive for Real Assets.

Property

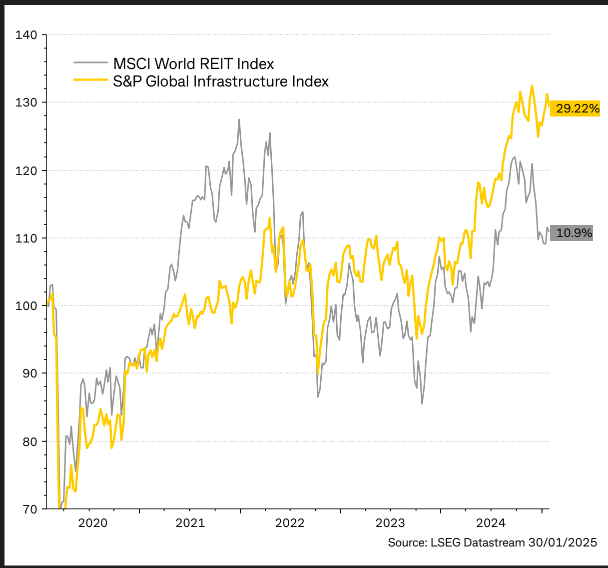
Returns from global commercial property investment have been challenged over the past couple of years as rising interest rates saw subdued investor demand, particularly with regards to the office sector, which was beset by the evolution of hybrid working arrangements during and following the COVID-19 pandemic.

The decline of commercial property valuations globally, combined with 'return-to-the-office' momentum (domestically at least), and market confidence that major central bank policy rates will continue to fall in 2025, is now resulting in cashed-up buyers looking for well-priced investment opportunities.

In the Australian market, offshore buyers are returning, and Australian super funds are looking to reposition and add to their property portfolios. This has been seen in the uptick of transaction activity seen in Q4 2024 and in early 2025 and bodes well for the return outlook for this sector over 2025.

Real Asset investment returns

USD Total Return



Infrastructure

The outlook for essential infrastructure in 2025 is also positive. Typically, returns from infrastructure sector investments are less volatile than equity investing, due to their existential need and their long-term and/or regulated cashflows. This typically provides strong stable revenue streams that considered a proxy for bond like coupon payments. Their cashflows may also be indexed to inflation, thereby providing a shelter against asset value erosion.

This asset class continues to evolve, bringing new opportunities to market in sectors such as energy transition, digital infrastructure, and waste recycling. It also encompasses the necessary refreshment and upgrade to electricity infrastructure (such as electricity grids and energy storage), which will provide a base for infrastructure investment and returns in the decade to come.

Alternatives:

A lot to like in this space

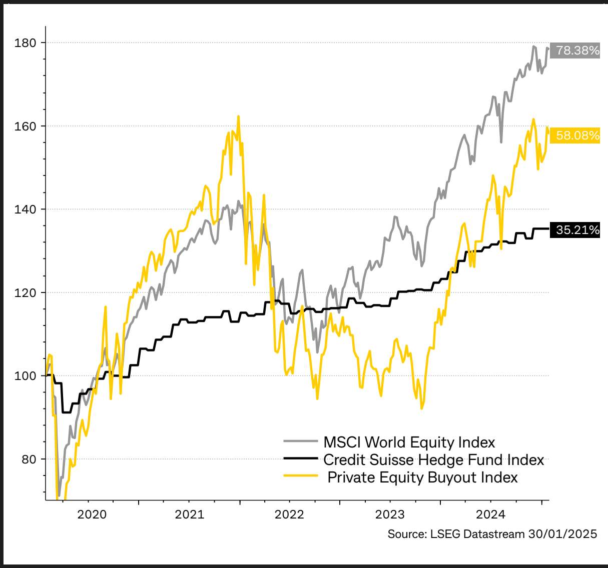
- Hedge Funds aim to provide absolute returns with low correlation to traditional asset classes.
- Alternative Credit offers enhanced yields.
- Private Equity offers access to value-added opportunities and participation in developing businesses and technologies.

Over 2024, and into January 2025, major global listed equity indices approached record highs, and corporate debt credit spreads tightened to historical lows. While these movements reflect strong corporate fundamentals and ample investor risk appetite, such conditions are a compelling reason to consider Alternative Assets, given their ability to provide positive returns over the medium-term, de-correlated from traditional asset classes.

Hedge Funds
Individual hedge fund managers can provide strong returns over time, by accessing return drivers with reduced correlation to traditional markets. Combining multiple strategies or funds within a portfolio can provide additional portfolio diversification and a measure protection in case of market selloffs.

Private Equity
Large technology companies have contributed strongly to the rise of major global equity market indices over the past two years, buoyed by investors looking to participate in the growth of AI, cloud computing, and associated industries. Private Equity (PE) can provide an alternative channel to access growth strategies. Since 2022, PE managers have generally been patient in investing capital, waiting for more attractive entry valuations before investing in new transactions.

Alternative investment returns
USD Total Return



This resulted in a buildup of capital waiting to be deployed. In late Q4 2024 and early 2025, signs are emerging that this "dry powder" is now becoming more mobile, seen via an uptick in merger and acquisition activity and the return of PE managers to market to raise more capital.

Alternate Credit
Alternative credit funds can provide attractive returns, underpinned by the increase in short-term floating interest rate benchmarks since 2022. Noting the contraction of credit spreads since 2023, we maintain our preference for experienced specialist managers that diversify investments across multiple credit strategies, such as private lending and asset backed securities, with a strong focus on risk awareness. We continue to be cautious regarding private lending to real estate development projects in Australia, as builders and developers continue to digest elevated construction and interest costs, which presents elevated risks to lenders.

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