Commonwealth Private

March 2025

Market Outlook.

Look through the fog.
Focus on the fundamentals.

Foreword

Global equity markets have had a choppy start to the year with competing narratives driving sentiment. Investors' concerns around US trade policy, AI competition and central bank activity are all creating headwinds for markets. However, the global economic cycle remains underpinned by the US and supported by robust labour markets, and healthy corporate and household balance sheets. Corporate earnings season in the US is better than expected, with both the percentage of companies reporting positive results compared to expectations and the magnitude of those results are above the 10-year averages.

President Trump's first month has brought a steady flow of executive orders focused on government cost-cutting measures, immigration enforcement actions and the threat of tariffs on the US's largest trading partners, China, Canada and Mexico. This latter is significant when you consider that 42% of US imports (~5% of US GDP) comes from these three countries. Rough estimates suggest that this will take the average US tariff on goods to around 10%, its highest level since 1946. While this may be negotiating tactics from Trump's administration, uncertainty is high and creating market volatility.

In February, Chinese-developed DeepSeek, a new lower-cost AI alternative using open-source large language models, garnered significant attention for its sophistication, rivalling US mega-tech at a reported fraction of the cost. This raised market concerns over the massive spending of mega-tech companies, and the rapid ascent of dominant chipmaker Nvidia.

While we believe it's far too early to judge the long-term implications of the DeepSeek developments, or even know for sure the exact development costs, any decrease in expenses is likely to further accelerate the adoption of AI on a broader scale into business processes.

Nevertheless, DeepSeek's emergence, propelled by a meeting between President Xi with Chinese tech leaders caused the market to reassess the unbridled optimism around the US mega-cap AI stocks. Investors should continue to pay attention to extremes in relative valuations and concentration. The top-10 stocks now account for almost 39% of US total market cap and carry an average forward P/E of 29.6 times.

Over in the US, Q4 reporting season has seen a positive earnings surprise among those companies reporting, with 76% have reported actual EPS above estimates. This is slightly above the 10-year average of 75%, and earnings growth was seen across multiple sectors. Encouragingly, the earnings growth rate sits at 16.9% for the quarter – the highest year-over-year rate reported by the index since Q4 2021.

In our domestic market, share price reactions to results have been pronounced in many cases, reflecting full valuations across the broader market, which has left little room for error. Volatility was particularly evident among large index weights, such as financials.

On the interest rate front, lower than-expected inflation in January allowed the Reserve Bank of Australia (RBA) to deliver the highly anticipated rate cut. At the same time, the RBA pushed back on expectations for further easing in the near future, with the tight labour market sighted along with further progress needed on inflation.

Elsewhere, the US Federal Reserve (Fed) threw cold water on markets at their December meeting with more subdued forward guidance toward rate cuts. This theme has carried forward with the January FOMC meeting reiterating a commitment to patience and a data-driven framework as officials await clarity on how the Trump policies impact the economy.

Global Economics:

Cruising but possible turbulence ahead

The global economic backdrop remains on a solid footing, led by the US, where both economic growth and the labour market is stronger than expected despite domestic political uncertainty and continued weakness in the housing sector.

In the US Core CPI was notably stronger than expected in January, and even outpaced last year's increase, contrary to expectations that residual start-of-year strength would be more muted as inflationary pressure ease. Core CPI rose 0.45% month-over-month, above expectations, and the year-on-year rate ticked up to 3.26%. Comparatively, last year's strength was more broad-based across services prices while this year's strength was more concentrated.

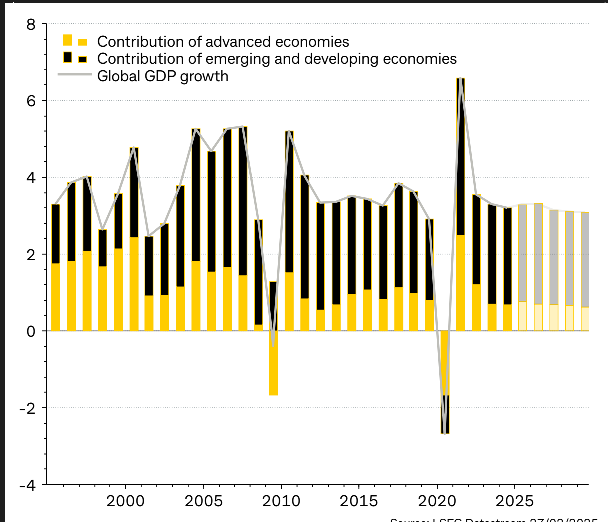
Strong price pressures remain in certain components, but overall it's not as broad. The minutes to the FOMC's January meeting noted that the vast majority of participants judged that the Fed Funds rate was still in restrictive territory, though participants said they wanted to see further progress on inflation before making adjustments to the monetary policy stance. This led to an unwinding of rate cut optimism playing out in bond futures markets.

Last month, bond futures traders saw a roughly 23% chance that the Fed would cut rates by 0.25% in March, according to the CME FedWatch Tool. Today, those odds have dwindled to below 5%. Overall, markets are pricing just one or two more 0.25% cuts for the remainder of 2025, compared with expectations for six or seven rate cuts just six months ago.

In contrast, the path of the European Central Bank's (ECB) rate cuts seems clearer. Recent data out from Europe indicated that the Eurozone economy stagnated in Q4 2024. That meant annual GDP growth for the region is estimated at 0.7% for 2024. This allowed the ECB to cut interest rates, as expected. ECB President, Christine Lagarde, also warned that economic risks are tilted to the downside.

Downside growth risks are fading

Global GDP Growth Expectations



Source: LSEG Datastream 27/02/2025

This weakening trend has only accelerated in recent months on concern that the labour market is softening and a trade war with the US could drag an already weak economy even lower.

In China, data published over the past month confirmed that the economy grew by 5.0% throughout 2024, its exact growth target. Q4 GDP surged to 5.4% year-on-year, up from 4.6% year-on-year in Q3, marking the highest level of the year, and the fastest year-on-year growth of any quarter since Q2 2023. Nevertheless, the data on prices remained weak, and it may still take time for domestic demand to recover as the uncertainties of external demand, household consumption, and the real estate industry continue to weigh on the economic performance of China in 2025.

Australia Economics:

The RBA cuts rates hesitantly...

- The RBA finally joined the global easing cycle but remains cautious on further near-term cuts given the upside risks to inflation.
- The economy continues to operate at two-speeds with record high public spending offsetting weak private sector growth
- Overall, economic growth will gain support this year from rate cuts and strong public spending, with a key risk being a return to global inflationary and rate pressures.

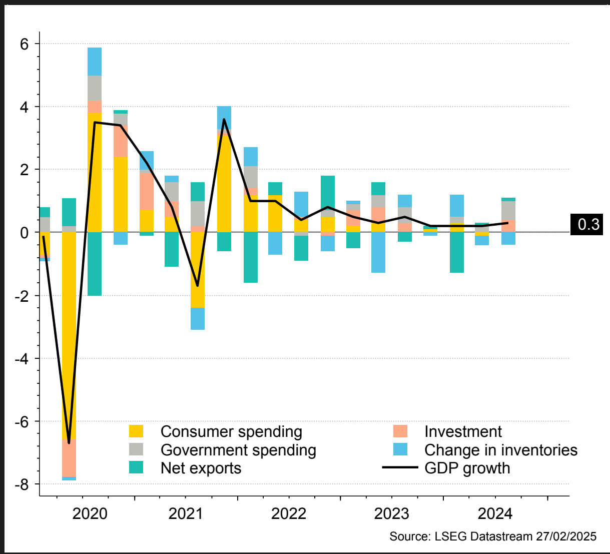
The RBA finally joined its major global central bank peers and eased policy by 0.25% in February. While this was expected, and monetary policy is still in restrictive territory, the outlook suggests further relief isn't immediately on its way with Governor Bullock at pains to point out the risks to inflation.

Australia's low unemployment rate certainly means the RBA can move slowly in normalising the cash rate. The most recent labour data confirmed the sound growth in jobs and a low 4.1% unemployment rate, albeit this is lagging indicator. Unemployment remains lower compared to the RBA's peak estimate of 4.2%, which was recently revised down from 4.5%.

Employment continues to be underpinned by the public sector however, which sees the domestic economy still operating at two-speeds. That is, record high public spending (and direct impacts on key State government budgets) is offsetting anaemic private sector growth, as evidenced in February's CommBank spending data which confirmed that consumers remained cautious in early-2025.

Australian GDP remains below trend

GDP growth and contributions to quarterly growth



A dramatic improvement in private sector investment and consumer spending isn't expected based on one 0.25% rate cut from the RBA - renewed uncertainty from President Trump's global tariff policies and a pending Federal election by 17 May, means Australian companies will likely remain hesitant in terms of their growth and spending plans.

Overall, though, having weathered the rate hikes over 2022 and 2023, the economy is expected to gain support this year from rate cuts, albeit growth will remain below trend. We expect the RBA to gradually ease policy further via a quarterly cutting pace giving a total of circa 0.75% of easing by the end of 2025.

Despite most global central banks now on an easing path, long-term rates remain elevated, in line with our higher for longer central case. A key risk to this domestic outlook is a return to inflationary pressures and even higher interest rates.

Finally, record high public spending is likely to have negative credit rating consequences (and thus, higher financing costs) for key Australian states, notably Queensland and Victoria, unless budgetary repair is invoked.

Equities:

Returns likely to moderate

- Returning to fundamentals
- The market is reassessing Australia's growth and interest rate environment
- Reporting season delivers mixed results

Since late last year, the equity market has been consolidating at elevated valuation levels, following two years of strong returns. While the inflation is easing in the developed world, the views on economic growth and pace of further rate cuts are not all unified. Market apprehension has also increased because of the US tariff policies proposed by the Trump administration and any potential tic-for-tac counter policies by other economies.

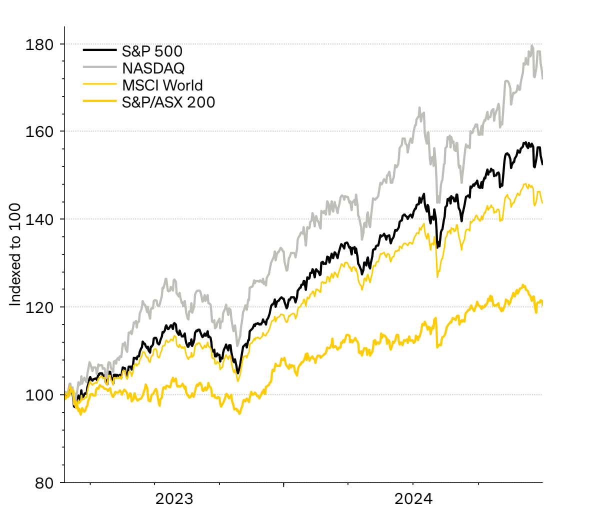
Under a very uncertain policy setting, the messages coming out from the equity reporting season so far have been mixed. While corporates have in general benefitted from easing cost pressures, the confidence on top line growth is somewhat subdued.

The US reporting season has indicated a stronger earnings performance than that on the revenue line. According to FactSet, up to mid-February, 77% of S&P 500 companies have reported Q4 results. Among that, 76% have reported a positive EPS surprise and 62% with a positive revenue surprise. For Q4, the blended year-over-year earnings growth for the S&P 500 is 16.9%, which if staying there to the end of the quarterly reporting season, will mark the highest growth rate since Q4 2021. However , the blended revenue growth rate for Q4 was not as strong as earnings, sitting at 5.2%, below the 5-year average of 6.9%.

In Australia, the recent sell-off of banking stocks have almost overshadowed the earnings season itself.

Equities had a stellar year

Strong total returns for major indices in 2024



Source: LSEG Datastream 27/02/2025

Sentiment soured after Bendigo and Adelaide Bank, reported a set of worrying results, as the bank grew fast in lending volume but at a substantial cost of margin contraction. Although the interim results from CommBank, largely met investors' expectations with no negative surprises, the quarterly updates from the other three major banks raised some concerns, including small declines in net interest margin, creep-up in credit impairments, and lower-than-expected capital ratios. We have previously noted that it is increasingly hard for the banking sector to keep its outperformance against the broader market with a largely flat earnings outlook, amid a falling official interest rate environment.

While the reporting season hasn't wrapped up yet, we've seen a strong push towards investors re-focusing on fundamentals and valuations to reassess their positions. Investors should inevitably dive into the nuances of the reported numbers, management analysis as well as outlook statements, to look for future investment opportunities.

Fixed Income:

Rates remain higher for longer

- Market yields remain elevated despite the global policy easing cycle, now including the RBA.
- Higher for longer global interest rates (but also market volatility) remains the central case. This offers elevated yield potential for investors but also guides our preference for actively managed fixed income portfolios that employ moderate interest rate exposure (duration).
- US and domestic credit spreads remain tight but gain support from economic and credit fundamentals.

Domestic and US market yields have remained elevated recently despite the RBA initiating cash rate normalisation. This reflects a combination of global factors including the market's revision of Fed policy and a watchful RBA. As a mainstay US bond investor, we also note that China has now reduced its holdings in US Treasuries to the lowest level since 2009.

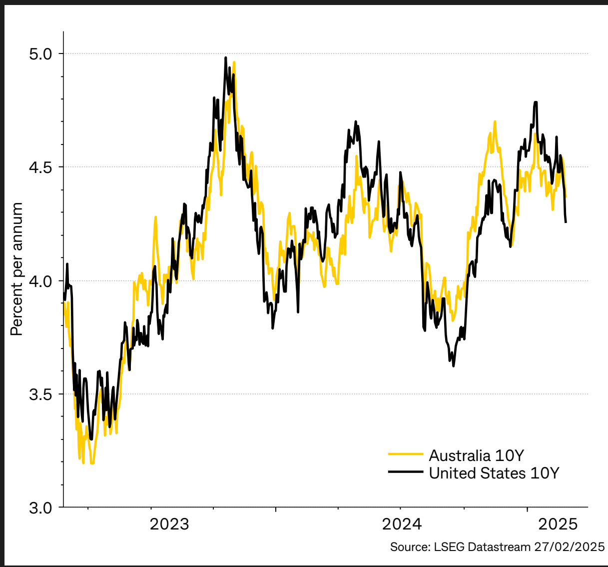
With 10-year USD and AUD bond yields up at circa 4.5% as of late-February, the US bond market is now pricing only one Fed rate cut in 2025.

The uncertainty surrounding the pace of further policy easing both here and, in the US, is also keeping bond market volatility at elevated levels. A higher for longer interest rate environment offers elevated yield potential for fixed income investors. However, structurally higher rates volatility guides our preference for restrained duration in bond portfolios and investing via diversified fixed income credit portfolio managers that manage interest rate (and credit spread) risks.

With the RBA now embarking on its easing journey, this will keep downward pressure on the shorter-term rates for cash-like products. Already, term deposit rates have reacted downwards, and thus, the window for investors to move from short-term products to lock in longer-term yield potential is closing.

Long bonds yields remain high

10-year Government Bond Yields %



Global credit spreads are not pricing in much room for error, especially in the US, hence our preference for higher quality, investment-grade credit issuers. However, credit spreads continue to draw support from solid economic and credit fundamentals, with updated US aggregate credit metrics showing that corporate gearing and interest covers strengthened further in the quarter to 30 September 2024.

Together with firm US economic conditions, this provides support to tight credit spreads in the US. A similar dynamic is in place for the domestic economy, which will benefit from further rate cuts over 2025. With solid fundamentals and market liquidity, macro risks represent a key risk to tight global credit spreads in our view – that is, a return to inflationary pressures and rising rates given the pro-growth and tariff imposition agenda of the Trump government.

Real Assets:

Solid foundations

- 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 the interest rate cutting cycle firmly entrenched, and expectations for major central banks to either maintain or cut rates further over the remainder of 2025, the outlook is positive for Real Assets.

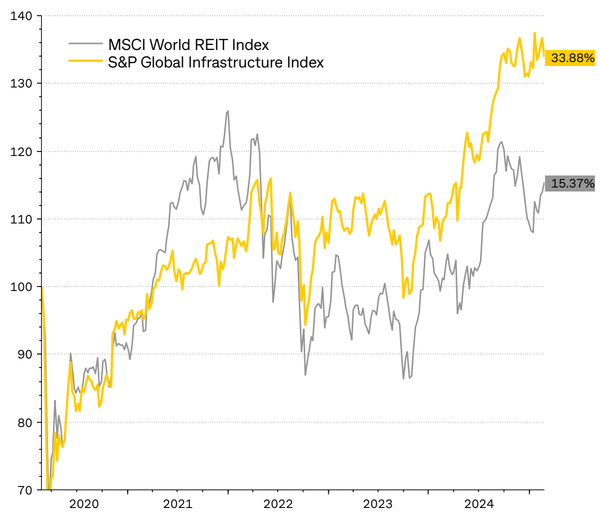
Returns from commercial property investments have been challenged over the past couple of years as rising interest rates subdued investor demand and impacted valuations. The office sector has also been impacted by hybrid working arrangements, which has increased vacancy rates.

Despite this, the outlook for commercial property has improved over the past six-months, as investors have become more confident that major central banks will maintain their easing bias, or at least not tighten in the near future. This includes the Australian commercial office sector, which has seen wholesale portfolio valuations stabilise in the December 2024 quarter. However, a significant number of properties are available for sale, as some current owners need to sell assets to either reduce gearing levels, satisfy redemption requests, or rebalance portfolios. This leaves the potential for further measured valuation declines in 2025.

These conditions have resulted in an uptick of transaction activity in Q4 and into early-2025. One example of this in Australia was the sale of the ASX-occupied building at 20 Bridge Street, Sydney, for a reported $250 million (Source: Australian Financial Review), which represents a decline of -25% since the property last traded in 2017. While this percentage decline is similar to other CBD office declines since early-to-mid 2022, it's more significant, given the broad ramp-up in office sector valuations between 2017 and the end of 2021. Contributing to this property's valuation decline is ASX's planned relocation later this year. This highlights the importance of individual property selection and ongoing engagement with tenants to maintain high occupancy levels.

Real Asset investment returns

USD Total Return



Source: LSEG Datastream 27/02/2025

While listed property securities have now recovered significantly from the sector-wide selloff across 2022 and 2023, global indices representing this sector have yet to recover back to the highs of late-2021.

Our outlook for infrastructure investments in 2025 is positive. Typically, returns from infrastructure investments are less volatile than equity investing, due to their existential need, long-term and/or regulated cashflows, and potential for providing a hedge against inflation. This asset class continues to evolve, bringing new opportunities to market in sectors such as energy transition, digital infrastructure, and waste recycling, which will provide a base for infrastructure investment and returns in the decade to come.

Alternatives:

Many levers to pull

- 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.

RBA's February cash target rate reduction was long anticipated by the market. In combination with the growth in domestic household income, it provides for an increase in disposable income and the potential for an uptick in discretionary spending.

This is positive for both domestic Residential Mortgage-Backed Security and corporate lending spreads, especially given the context of the overall above-expectation corporate reporting in January and February 2025, and that Australian residential mortgage arrears rates aren't elevated.

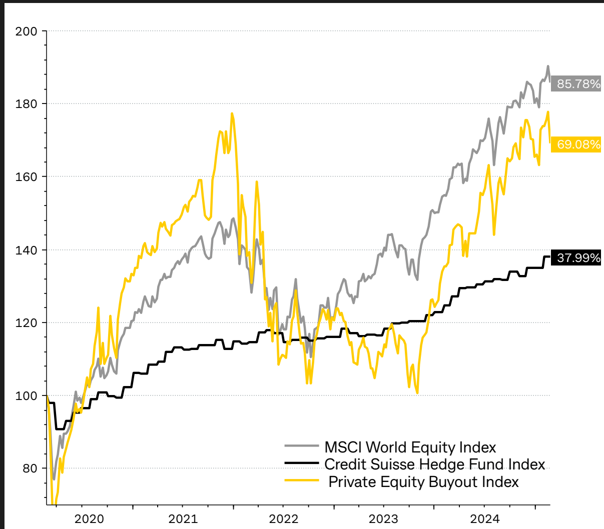
In the US, the overnight financing rate has already declined by about 1% over the 12-months to end-February 2025, while corporate operating conditions in the US generally continue to be positive.

As such, our near-term outlook for alternative credit assets is stable. Absent any material shocks to the system, we expect credit spreads for high yield assets, including private credit and asset-backed securities, to remain supported around their current historically tight levels.

However, with yields from many such credit assets being calculated according to a floating reference rate plus a margin, ongoing distribution returns from floating rate-based credit strategies are likely to have passed their peak levels in 2023 and 2024.

Alternative investment returns

USD Total Return



Source: LSEG Datastream 27/02/2025

One factor that we will continue to watch closely over the coming months is the imposition of tariffs by the US, which are likely to be inflationary. So far, according to US interest rate markets movements in February, these tariffs are currently expected to slow the US easing cycle, rather than trigger a new round of policy tightening.

In this environment, with the potential for US tariffs to impact some sectors more heavily that others, judicious risk-aware credit selection will be paramount to navigating the year ahead successfully, rather than relying on passive long duration to deliver returns.

Meanwhile, Private Equity will continue to provide access growth strategies. In this regard, while lower interest rates will benefit most companies, the selection of companies in technology and service industries, as well as other capital-light businesses, should be preferred over resource-heavy industrials.