



WILSONS
ADVISORY

Great Expectations

Our first quarter asset allocation strategy.

29 January 2024

The Big Wait for Lower Rates

Easing inflation, slower but still positive economic growth, and lower interest rates should provide a supportive backdrop for equities and fixed interest in 2024.

Volatility may rise in the short term after the strong investment gains of recent months, however, we see the 6 to 12 month return outlook as constructive.

On a 12-month view balanced portfolios should perform reasonably well as both equities and bonds post positive returns. Fixed interest continues to offer the most attractive risk return trade-off of the major asset classes, in our view. We remain 3% overweight. While we remain constructive on the 6 to 12 month outlook, we have trimmed our allocation to global equities back to neutral after the strong recent run-up.

We remain neutral on Australian equities. Alternatives offer opportunities to further diversify risk and access additional sources of return. We reallocate at the margin from global equities to alternatives. We remain underweight on cash. Fixed interest is likely to produce superior 12 month returns to cash in our central case and "risk" case view.

Our core macro view: balanced fund positive

As discussed last week we remain constructive on the US inflation trend and the ability of the US economy to keep growing in 2024.

Read [Is the Fed Running Late to the Goldilocks Party?](#)

This US soft-landing view has for some time been the key to our constructive view on equities as an asset class. However, in the short term the aggressive interest rate repricing and the consequent US equity surge may have gotten ahead of itself. A period of consolidation (or a moderate correction) in equities is likely in our view, with a recalibration of rate cut timing potentially cooling recent exuberance. In addition, the big US equity rally sets the bar high for the unfolding US earnings season.

Our caution at this juncture is more short term than medium term. We don't see enough downside to raise cash levels. Our base case view of stocks and bonds both performing reasonably well over the next 12 months anchors our equity positioning, though we see the risk-return trade-off for fixed interest as more attractive at this point in the cycle.

Figure 1: Asset allocation weightings and key views

Asset Class	Tactical Tilt	Movement	Wilson's View
Cash	Underweight -3%	no change	Underweight as fixed interest is likely to produce superior 12-month returns in our central case and "risk" case view.
Fixed interest (Domestic & Global)	Overweight +3%	no change	Australian bond yields look good value and should insulate portfolios from weaker than expected economic conditions.
Equities - Domestic	Neutral	no change	Australian equities lack near term earnings growth but growth should resume beyond 2024 and valuations look reasonable.
Equities - International	Neutral	-1%	An improving global inflation outlook and central bank easing should be supportive, however International equities look overbought near term. Partial hedge back to the A\$ as we believe the A\$ has upside against the US\$ as the Fed cuts.
Alternatives	Neutral	1%	A range of growth and defensive alternative strategies appeal, particularly domestic private credit. Gold (A\$ hedged) appeals as a portfolio hedge against geopolitical risk and as a beneficiary of a peaking Fed & US\$ unwind.

*Our tactical tilts represent our view over the next 6 to 12 months though active tilts could be held for shorter or longer periods depending on both asset class performance and fundamental developments. Source: Refinitiv, Wilson's Advisory.

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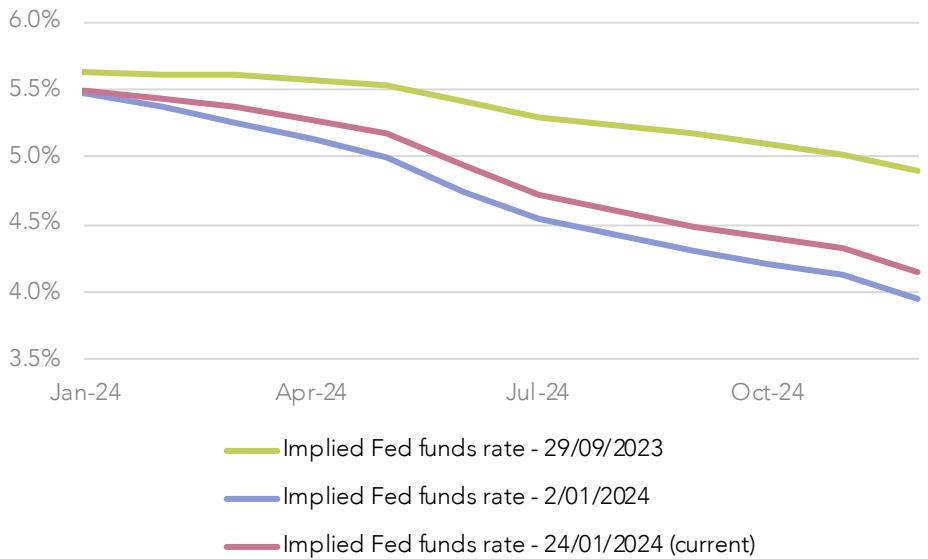
Will inflation come down fast enough for central banks to ease policy significantly in 2024?

Last week we discussed the dramatic re-pricing of the Fed easing cycle that flowed from the mid December meeting when Fed Chair Powell did not push back on the market's notion of relatively imminent rate cut relief.

This pricing has shifted again somewhat in the last few weeks with the market backing off from its aggressive pricing of an initial March rate cut, taking down the probability from 95% to just 40%. This has seen the US dollar bounce and bond yields rise marginally, though US equities have largely defied the adjustment, with a renewed burst of tech-centred optimism taking hold.

The US interest rate market has still not completely abandoned the idea of a March rate cut, and still has between 5 and 6 cuts through the remainder 2024. Is there a risk the market has to aggressively re-price the pace and quantum of rate cuts in 2024? Our base case is that any readjustment is at the margin. CPI inflation could still appear sticky over the next couple of prints with the housing component in particular being slow to come down. This could move the market to delay the timing and pace of rate cuts somewhat.

Figure 2: Expectations for Fed easing increased dramatically toward the end of 2023



Source: Refinitiv, Wilsons Advisory.

The picture is potentially messy with the possibility for comparatively better prints out of the other key barometer of US inflation, the core PCE (due 26 January), in part due to its lower housing weighting. However, both measures should ease over the balance of 2024, so ultimately, we are not overly worried about the need for major recalibration of Fed easing assumptions.

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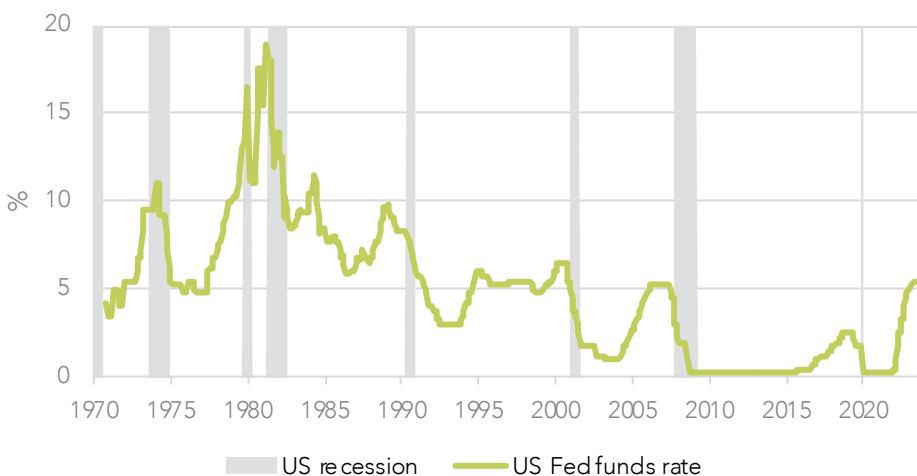
Could the US economy finally falter due to the Fed's aggressive policy tightening?

The US economy has surprised with its resilience over the past year, defying consensus expectations of a 2023 second-half recession. In line with our long-held thesis, resilience has been a function of some unique factors in this cycle, namely excess savings built up in the pandemic combined with an historically tight labour market, which has supported robust consumer spending levels. So far this year US activity data has continued to be on the strong side of consensus.

A larger-than-expected slowdown in the US economy still looms as a risk for 2024. Real interest rates do look to be well above almost all estimates of a long-term equilibrium level and monetary policy has always worked with a lag, so we continue to monitor the US economy closely.

We are watching the labour market and consumer stress for cracks in the soft-landing scenario but it remains our central case. While the US consumer has demonstrated resilience, the key tailwinds that fuelled spending growth in 2023 are now fading. Excess household savings are now largely depleted.

Figure 3: US soft landings are rare



Source: Refinitiv, Wilsons Advisory.



A degree of consumer resilience is still expected due to rising real wage growth, although higher consumer credit charges, recommencement of student loan repayments and a slight deterioration in job security will cap willingness to spend. Given the US consumer is one of the most important drivers of global economic activity, consumer confidence surveys and spending data will be key signposts to watch in 2024 to gauge the extent of the slowdown.

A key signpost for the US growth outlook over coming months will be employment data, with a focus on more frequent and alternative data such as, jobless claims, job listings and hiring surveys, potentially giving a timelier guide on any impending slowdown in employment. We expect payroll growth to taper gradually to a trend, or marginally below trend pace later in the year, but avoid an outright contraction.

In summary, while US soft landings have proven to be the historical exception rather than the rule, the evidence at present is that the US economy is slowing in a relatively orderly fashion and remains on track for a soft landing in our view.

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Could one or more geopolitical events derail investment markets?

While geo-political concerns loom large in 2024 investors should avoid the temptation to de-risk on the basis of worst-case geo-political scenarios. The most likely scenario remains that investment markets continue to look through the still relatively contained conflicts in Eastern Europe and the Middle East. The end year US election will increasingly capture investor interest, but we believe the US election is unlikely to dramatically move markets regardless of the result.

Geopolitical tensions in the Middle East have increased. Recent weeks have seen a series of drone and missile attacks on commercial shipping in the Red Sea and subsequent US-led airstrikes in Yemen. In response to the Red Sea attacks, more trade is being diverted to safer though more costly routes.

While the conflict is now wider at the margins, our base case is that we do not expect an escalation that would alter our constructive views on equities in 2024.

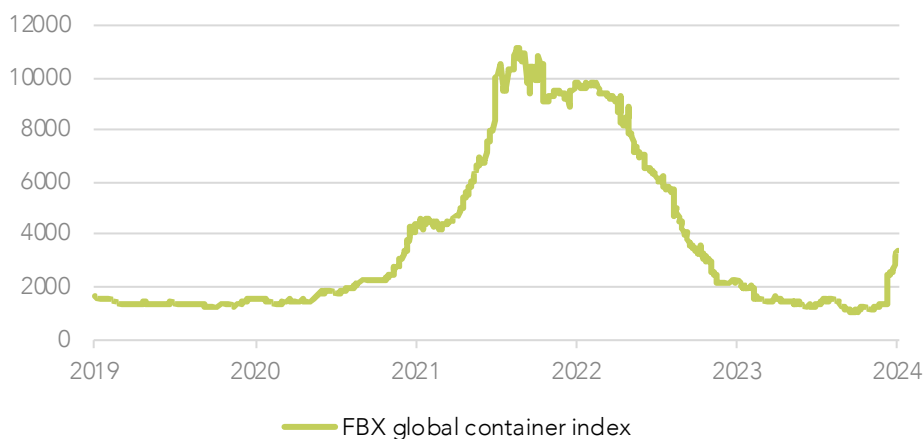
We don't believe the war in the Middle East will drive meaningfully higher global inflation. The availability of an alternative route means that while shipping faces delays and higher costs, major outright shortages should be avoided. This should limit the inflationary effects. This is notably different from during the pandemic, when goods production was shut down or constrained. It is also different to the initial stages of the Russia-Ukraine war when commodity supplies were restricted, or disrupted, leading to very sharp rises in key commodity prices.

While the cost of shipping containers from Asia to Europe has risen, the impact on other routes has been much more limited. Indeed, the Baltic Dry Index, the global benchmark for the price of moving raw materials by sea, has declined in recent weeks.

With respect to oil, our base case is for no significant disruption to oil supplies. We believe Brent crude prices are likely to range trade in the months ahead before picking up as global growth accelerates into 2025.

2024 is also the year of the general election. Earlier this month, elections in Taiwan resulted in a status-quo outcome, although China Taiwan relations are likely to remain a constant source of geopolitical tensions in the coming years. With US presidential primaries moving into full swing, attention is now turning to November's US presidential elections. At this early stage we see the election as too close to call. With former president Trump a very warm favourite as the Republican nominee, we think some of the more negative scenarios flowing from a Trump victory are likely alarmist. The market is likely to take a Trump return in its stride, despite the prospect of greater political noise in coming years.

Figure 4: Recent Red Sea attacks have pushed up freight costs (US\$ per container)



Source: Refinitiv, Wilsons Advisory.

Are US Equities Back in a Valuation Bubble?

The notion of US equity overvaluation has been a common refrain from many perma-bears for much of the last 10 years. We have for the most part been more sanguine on US valuations, pointing to the quality, track record and strong growth outlooks for US mega caps. Valuations did become overvalued in 2022, although the big shift in inflation and interest rates accentuated the correction.

The US multiple at 20x 12-month expected earnings is once again becoming stretched. We don't currently see the big macro driven correction catalysts evident in 2022, however there is the risk of some downward adjustment in coming months. At a minimum, significant further re-rating over the coming year looks unlikely. The reality that US market valuation is less attractive than it was is in part behind our trimming of global equities back to neutral.

We see the "trend level" of the US market at around 18-19x. AI excitement and rate cut bullishness may keep the US multiple elevated but we are reluctant to chase, particularly when combined with relatively bullish investor positioning and sentiment signals (in contrast to 12 months ago).

The US earnings environment in 2024 is likely to be relatively benign albeit not strong enough to see equities re-rate. We continue to see mid-single-digit earnings growth in the US in 2024.

Figure 5: US market multiple is looking stretched again



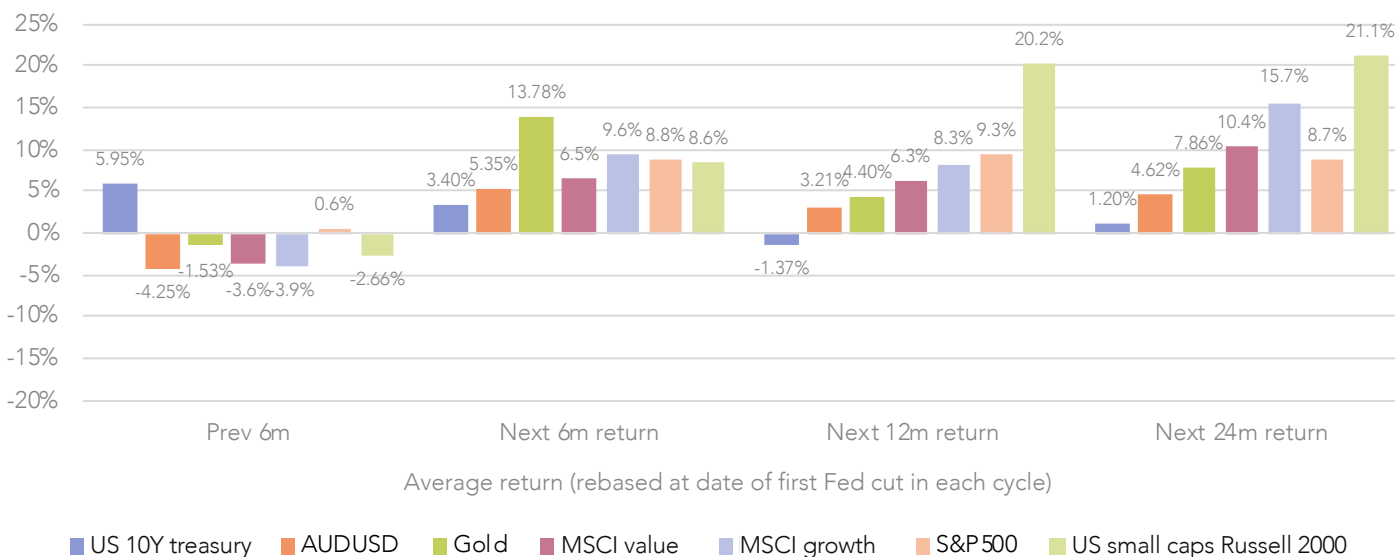
Source: Refinitiv, Wilsons Advisory.

This is below current estimates of 11% but downgrades are the norm in most years. Investors should be concerned about big downgrade years when earnings growth turns decisively negative, not some moderate downgrading to still respectable levels of earning growth.

Other equity markets look simplistically cheaper relative to the US. The "rest of world" looks notionally attractive, as do small caps. The rest of the world likely has a weaker earnings outlook in 2024 relative to the US (particularly Europe), however rate cuts may see the market look through this earnings softness. We note small caps and global value typically do well in response to Fed easing. We have edged up our weighting to both small caps and global value.

EM equities have looked attractively valued for some time and have also historically done well in response to Fed easing, given the usual association with a weaker US dollar (US\$). While many EM markets delivered decent returns in 2023, China has been a significant drag on performance. Consumer and local investor confidence in China is low, as is global investor confidence. We don't see a lot of residual downside given very low valuations and washed out sentiment but there seems to be increasing risk that China remains locked in a "muddle through" economic cycle with piecemeal stimulus keeping a full-blown crisis at bay but no meaningful recovery eventuates.

Figure 6: Fed easing has particularly helped small caps historically



*Cycles include 1989, 1995, 2001, 2007, 2020. Source: Refinitiv, Wilsons Advisory.

Another cut in the banking sector reserve requirement (24 January) is the latest economic support measure, but the economy likely needs more comprehensive support and reform. From this perspective we decrease EM to neutral. A mix of low valuations and double-digit overall earnings growth forecasts suggest EM remains attractive for the patient, but at present there are no near-term catalysts to spark global investor flows. A meaningful weakening in the US\$, or meaningful China stimulus are the key catalysts we would look for to be more constructive.

Australian Economic and Asset Class Outlook

The Australian economy has weathered the rise in policy rates reasonably well so far but has settled into a slowing growth trajectory. We expect real gross domestic product (GDP) to average a sub-par to 1.5% in 2024. Nevertheless, this would constitute a soft landing for the economy with a pick up likely in 2025 in response to policy easing later this year.

GDP growth will be dragged down in 2024 by the lagged impact of rate rises but growth will be supported by strong population growth, ongoing infrastructure spending and some moderate second half tax cut relief.

The labour market has moderated over recent months, with a slower pace of employment and hours worked. The unemployment rate remains very low but is now edging up. However, at 3.9% it still remains below the RBA estimate of full employment. We expect the unemployment rate to edge higher this year. This provides support to our view that the RBA has done enough and should be able to ease policy later in the year, albeit this is contingent on inflation entering a clear downturn.

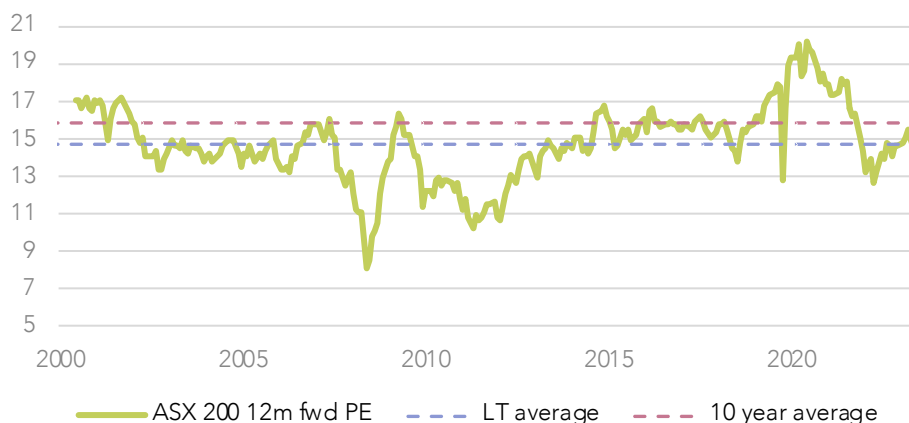
Encouragingly the monthly inflation data for November surprised to the downside. The full December quarter inflation release is the next key piece of domestic data (due 31 January) as the RBA heads toward its first meeting of 2024 under its new 6-weekly framework. We expect the quarter-on-quarter pace to step down from September's worryingly high 1.2% to a still high but encouraging 0.8%. This would leave core CPI at a still high year-on-year pace (4.4%). Therefore, an RBA rate cut is still a story for the second

Figure 7: Key equity market - valuation and earnings metrics

	MSCI World	US	UK	Europe	Japan	EM	Aust
1 Yr Fwd PE	18	20	11	13	15	11	16
CY24 EPS growth	10	11	4	5	14	17	0
CY25 EPS growth	12	13	8	9	8	15	6

Source: Refinitiv, Wilsons Advisory.

Figure 8: Australian multiples are not a bargain but not overly stretched



Source: Refinitiv, Wilsons Advisory.

Figure 9: The market needs a return of earnings momentum to generate sustainable gains



Source: Refinitiv, Wilsons Advisory.

half of 2024 in our view. The market is currently priced for just over one rate cut in 2024, beginning in either September or November. This seems a reasonable base case expectation at this point.

The prospect of monetary policy easing late in the year, helping the economy pick up in 2025, should all things equal support the local share-market and see it trade higher by year end.

Ultimately the local market should be buoyed by the prospect of lower global and eventually domestic rates and a better growth outlook as we

move toward 2025. Valuations do not look demanding and earnings growth estimates look realistic. We retain a neutral view for now.

The Australian dollar (A\$) is well off its lows of October last year, but has eased back a bit this year as the US\$ has re-strengthened and commodities re-trace. We expect a flat to marginally lower trend near term before the A\$ pushes up toward the 70-72c area by year end as the Fed eases faster than the RBA. We retain global equity hedging at just under 40%.

Alternative Assets – an Attractive Diversifier

We have edged up our alternatives weighting back to neutral in response to our trimming of global equities. We see alternative assets as offering attractive diversification and absolute return potential within a balanced asset allocation. We maintain a well-diversified alternative allocation spread across private equity, private debt, market-neutral hedge funds, infrastructure and gold. We continue to favour high quality domestic private credit, with attractive yields on offer (~9%). While the local economy is set to slow further, we do not forecast a recession and corporate balance sheets look strong for the most part. Legal protections in the Australian lending market are also relatively favourable, so we remain comfortable with a high-quality domestic private debt allocation.

Figure 10: Wilsons Advisory expected asset class returns

	Long Term Expected Returns	12 Month Expected Returns
Domestic Equity	8.0%	5-12%
Int'l Equity	8.0%	5-11%
Fixed Interest	4.5%	7-13%
Cash	3.5%	4.0%
Alternatives	6.0%	4-9%

*Long term expected returns are 5 to 10 year passive expected returns based on both historical performance and current pricing/yields. 12 month expected (passive) returns are shown as a range due to the inherent volatility of financial market returns. Performance and risk projections are subject to market influences and contingent upon matters outside the control of Wilsons Advisory and Stockbroking Limited and therefore projections may not be an accurate indicator of future performance and/or risk. Source: Refinitiv, Wilsons Advisory.

Infrastructure had a difficult time over 2022 and much of 2023 given the negative valuation impact of rising bond yields. While performance has been disappointing, infrastructure is well placed to benefit from a reversal in the long bond yield as growth slows,

due to its interest sensitivity and resilient cash flows. Finally, the prospect of the Fed easing multiple times this year should drive some renewed upside in the gold price over the next 6 to 12 months, hence we retain some exposure (A\$ hedged).

Figure 11: Asset Allocation summary

Asset class	High growth			Growth			Balanced			Moderate			Defensive		
	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt
Cash	0%	2%	-2%	0%	2%	-2%	2%	5%	-3%	7%	10%	-3%	17%	20%	-3%
Fixed Interest	6%	4%	2%	14%	12%	2%	25%	22%	3%	35%	32%	3%	50%	47%	3%
Equities - Domestic	40%	40%	0%	37%	37%	0%	30%	30%	0%	24%	24%	0%	12%	12%	0%
Equities - International	39%	39%	0%	36%	36%	0%	30%	30%	0%	23%	23%	0%	12%	12%	0%
• Emerging Markets	4%	4%	0%	4%	4%	0%	3%	3%	0%	2%	2%	0%	1%	1%	0%
Equities Total	79%	79%	0%	73%	73%	0%	60%	60%	0%	47%	47%	0%	24%	24%	0%
Alternatives	15%	15%	0%	13%	13%	0%	13%	13%	0%	11%	11%	0%	9%	9%	0%
• Growth	11%	11%	0%	8%	8%	0%	8%	8%	0%	6%	6%	0%	5%	5%	0%
• Defensive	4%	4%	0%	5%	5%	0%	5%	5%	0%	5%	5%	0%	4%	4%	0%
Growth Assets	90%	90%	0%	81%	81%	0%	68%	68%	0%	53%	53%	0%	29%	29%	0%
Defensive Assets	10%	10%	0%	19%	19%	0%	32%	32%	0%	47%	47%	0%	71%	71%	0%
Cash + Fixed Interest + Equities + Alternatives	100%	100%		100%	100%		100%	100%		100%	100%		100%	100%	

*Commentary references our Balanced Portfolio. Source: Refinitiv, Wilsons Advisory.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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